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# MINDING YOUR OWN BUSINESS

Volume 1

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Forecasting for an Existing Business .....	7
Forecasting for a New Business .....	17
Changes of Ownership .....	27
Presenting your Case for a Term Loan .....	43
Working Capital .....	55
Equity Capital for Small Companies ..	69
Managing your Current Assets .....	79
Managing your Fixed Assets .....	91
Managing your Cash .....	105
Giving Credit to your Customers .....	115
Paying your Employees .....	129
Personnel Records .....	143



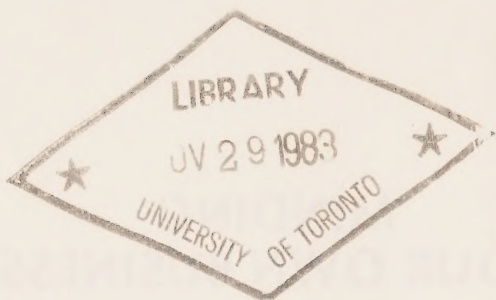


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# MINDING YOUR OWN BUSINESS

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# CONTENTS

FOREWORD .....	5
CHAPTER 1 Forecasting for an Existing Business .....	7
CHAPTER 2 Forecasting for a New Business .....	17
CHAPTER 3 Changes of Ownership .....	27
CHAPTER 4 Presenting your Case for a Term Loan .....	43
CHAPTER 5 Working Capital .....	55
CHAPTER 6 Equity Capital for Small Companies .....	69
CHAPTER 7 Managing your Current Assets .....	79
CHAPTER 8 Managing your Fixed Assets .....	91
CHAPTER 9 Managing your Cash .....	105
CHAPTER 10 Giving Credit to your Customers .....	115
CHAPTER 11 Paying your Employees .....	129
CHAPTER 12 Personnel Records .....	143



# FOREWORD

Small business is the driving force in the Canadian economy in terms of both output and employment. Collectively, small business is estimated to account for 25 percent of the gross national product and 42 percent of Canada's work force. There are more than 900,000 small businesses in Canada. They comprise sole proprietorships, family businesses and partnerships, small corporations, the self-employed, and professionals. It can be safely said that the majority of businesses in this country are small and independently owned.

It can also be safely said that a special characteristic of small business is its functional management. In many instances, one owner/manager manages every aspect of the business. This person, rarely a master of all management skills, has to be a general manager, sales manager, production manager, purchasing manager, personnel manager, controller, and research manager for the business, especially during its early years. It helps if the owner/manager understands marketing, quality controls, finance, banking, commercial law, and human relations.

This volume cannot be an exhaustive text on all that the small business owner must know. It does, however, introduce various concepts of financial and administrative management that are particularly important to small business.

The material in this book originally appeared as Pamphlet Nos. 2 to 14 in the series "Minding Your Own Business". This present volume has subsequently been revised, re-written, and updated with additional information so as to increase its usefulness for the prospective entrepreneur and the established owner/manager.

Since 1974, almost five million copies of "Minding Your Own Business" have been distributed to owners and managers of small businesses in Canada. It is hoped that this new edition of the pocketbook will prove to be just as popular and as helpful.



# 1. FORECASTING FOR AN EXISTING BUSINESS

*"A forecast is one of the most useful tools the entrepreneur has in planning the future course of his or her business."*

— CASE Counsellor

INTRODUCTION .....	8
WHAT IS FORECASTING? .....	8
WHAT IS THE VALUE OF FORECASTING? .....	9
HOW TO PREPARE THE FORECAST .....	10
CONCLUSION .....	16

# INTRODUCTION

Tomorrow's uncertainties are something with which we must all live. Often, a small business is more vulnerable to the uncertainties of the future than is the larger business. Although exact knowledge of the future is unobtainable, an idea of what to expect can be very helpful for the small business operator.

At best, you can estimate or forecast what you **think** may happen. Although this may seem like a guessing game, it can well result in changing the course of your business's future. In short, predicting what may happen helps reduce your uncertainties.

This chapter will show you why preparing a realistic forecast is important to your business. We will begin by defining forecasting and then explain its value. As well, this chapter will give you pointers on how to prepare a forecast.

## WHAT IS FORECASTING?

Forecasting will help you estimate your business's activities both financially and strategically.

1. Financially, forecasting means estimating the revenues, expenses and profits that your business will incur in a certain period of time in the future.
2. Strategically, a forecast can indicate the areas for growth and expansion whether in facilities or in products. A forecast can also point out activities that may need strengthening.

Generally, a forecast is prepared for a one-year period — the year following the year-end of the business's financial statements. This does not mean that forecasts should be prepared for only one-year periods. Many businesses find it very useful to prepare a one-year forecast and then divide it into shorter periods — say three to six months. In planning for the longer term, forecasts are often prepared for periods of two to five years in the future.

Having past financial records is the advantage that the existing business has over the new business. There is a distinct relationship between your business's past and its future. The information from past records can help you plan realistically for the future. Knowing where your business has been will help you determine where your business is going. However, your forecast must not be built solely upon the past; you must determine, as well, what changes you wish to occur in your business so as to provide input for the future and to help ensure growth.

Because forecasting involves a certain amount of guessing it is crucial that the forecaster has good, sound judgement. What you are doing, as the forecaster, is carefully combining objective data (your past records and known expenses) with subjective inferences about what you think the future may bring. To blend the two takes experience, not just academic knowledge.

## **WHAT IS THE VALUE OF FORECASTING?**

Preparing an operating forecast does not necessarily have to be time consuming. At any rate, the benefits you derive are well worth your time and effort. Let us take a look at some of the advantages a forecasting statement will provide:

- (a) A realistic forecast will point to what new facilities or expansions are needed. Because it gives you an opportunity to study the business's past results in detail, it may disclose opportunities to expand the business which might not be apparent during the hectic day-to-day operations of the business. Let us suppose that a motel/restaurant operator is studying her business's previous operating history. She might find that revenues from her small restaurant have been increasing quite substantially, even though there has not been any noticeable increase in the occupancy rate of her motel. The increase in restaurant revenues, if extended into the next year and subsequent years, might well cause this operator to examine the restaurant situation very closely and to give consideration to its expansion.

- (b) Forecasting will not only help determine what new expansions are available, it will also allow you to plan and schedule them. In other words, you may then make arrangements, or determine the feasibility, for obtaining the necessary capital to realize these plans. You may also wish to consider your various alternatives. For example: buying or leasing certain assets; putting up a new building or renovating the old one; changing the variety of products sold or produced.
- (c) Again because it requires a study of past experience, preparing a forecast can help in drawing the business operator's attention to certain expenses which should be watched closely.
- (d) Comparing a forecast with the results actually experienced will not only help in pointing out areas of opportunity but also those of concern. In looking ahead, preparing a forecast may help detect a problem before it is too late. For example, you may find that in spite of increasing revenues, profits have actually been slightly declining. Recognizing this slow decline today could prevent you from suddenly being unable to meet expenses or to make necessary purchases tomorrow. Such a situation would result in an analysis of your expenses to determine which of them were increasing and where reductions could be made.

The main point to remember is that a forecast is a tool that will help reduce your business's uncertainties by realistically determining, as accurately as possible, what factors may play a role in your business's future.

## HOW TO PREPARE THE FORECAST

Before starting a forecast, it is important that you prepare it on the basis of what your business has done and what your business can **reasonably** be expected to do. There can be a considerable difference between what your business is expected to achieve in the future and what you would like it to achieve. Naturally, we would all like to see our profits triple in one year. Realistically though, this is not very probable. It is essential that you keep this in mind while preparing your forecast.

Perhaps the first step in putting together a forecast is that you establish your objectives. In other words, that you know why you are forecasting. This is the only way your statement will have any value. Defining your objective will also indicate for what length of time you are going to forecast. If you are forecasting for the purchase of materials, you may plan a forecast for a year as opposed to a long-term forecast for capital expenditures which could cover a period of two to five years.

Your second step is to gather all pertinent information and data. Work with your business's most recent statements. Establish all the changes that you can realistically expect to occur in your business within the time frame of your forecast.

Now that both your objective and expectations have been determined, you can begin the third step: actually preparing your forecast. Your forecast will be an estimate of the following:

- sales
- cost of goods sold
- gross margin
- operating expenses
- profits

Let us examine each one in turn.

**Sales** In forecasting your sales, the logical starting point is your last year's sales figures. Quite often, identifying past trends will point to future ones. For example, if over the last two years your sales have increased by 15 percent, it is usually safe to assume that, given similar conditions, your sales figure for the year that you are forecasting will again increase by the same percentage. Of course, if you have plans that could affect your sales such as the introduction of a new product, changes in location, or a major advertising and promotion campaign, this percentage will have to be adjusted.

External factors must also be considered when forecasting your sales. In other words, you must analyze your market with questions such as: Is my share of the market growing or declining? Are there more or fewer competitors? What are they charging for the same or similar product? And you must recognize the effect of inflation, possible price increases, and the availability of inventory.

If you divide your forecast into months, your past monthly sales records will show you which months are more active than others. This trend may continue or be adjusted by known external factors or by the previously mentioned internal events such as an advertising campaign or the release of a new product.

It must be stressed that your sales forecast be as realistic as is possible. Too often, small business entrepreneurs, while showing realism in estimating cost of goods sold and expenses, will reflect too high an optimism in forecasting their sales.

**Cost of Goods Sold** There has to be a direct relationship between your forecast of sales and the cost of goods that you plan to sell. What if you are able to determine from previous years' figures that, say, 80 percent of your sales figure represents cost of goods sold? For many small businesses, you could then simply calculate future cost of goods sold by taking 80 percent of future sales.

For larger retailers and for most manufacturers, cost of goods sold must consider planned inventory levels. The retailer will want to be sure that there is a proper stock turnover rate that is related to sales. The manufacturer will be concerned that proper inventory levels in finished goods, goods in process, and raw materials have an accurate relationship to the sales forecast.

**Gross Margin** In simple terms, gross margin is determined by subtracting cost of goods sold from sales.

**Operating Expenses** Operating expenses are usually termed fixed and variable. Fixed expenses, such as rent and depreciation, are those required for the normal operation of your business. Variable expenses, such as advertising and wages, are those that will vary because of their close relationship to your sales. An increase in sales may be reflected in increased advertising expenses and additional staff. For the manufacturer, there will be a relationship between overhead, labour, and sales.

Your previous years' figures will help you forecast your operating expenses. For example, a steady 10 to 15 percent increase over the last couple of years can be a realistic factor to use in forecasting the next year's operating expenses. As we saw when forecasting sales, both external factors and planned internal events will affect your forecast of operating expenses.

**Profit** Subtracting your operating expenses from gross margin will give you the forecasted profit for your business.

To further explain a forecast, we show a profit and loss statement for a small business's fourth year in operation and the forecast prepared by the owner for the future — the fifth year. Here are some facts on our hypothetical small business:

The business operates from leased premises. The rental is \$800 a month with the landlord paying utilities and realty taxes but not business taxes. The owner is thinking of buying a building instead of the present lease arrangements.

Additional space in the new premises will permit the carrying of additional lines. The new location will also mean more customers. Business revenues are expected to increase from \$300,000 to \$350,000. Cost of goods sold over the last four years has been 80 percent. The building will cost \$35,000 and the land \$15,000. A loan of \$30,000 will be arranged at the current interest rate.

# **Profit and Loss Statement for Fourth Year**

Sales		\$300,000
Cost of Goods Sold		<u>240,000</u>
Gross Margin		60,000
Operating Expenses:		
Wages — part-time clerk	\$10,000	
Salary — owner	20,000	
Overhead	nil	
Depreciation — fixtures	1,000	
Delivery expenses	3,000	
Telephone	400	
Interest	300	
Insurance	500	
Advertising	2,000	
Delivery vehicle repairs	675	
Bad debt expenses	500	
Rent — \$800 per month	9,600	
Business taxes	400	
Realty taxes	<u>nil</u>	
Total Operating Expenses		<u>48,375</u>
Profit before Taxes		<u><u>11,625</u></u>

### Forecast for Fifth Year

Sales		\$350,000
Cost of Goods Sold		<u>280,000</u>
Gross Margin		70,000
Operating Expenses:		
Wages — part-time clerk	\$12,000	
Salary — owner	22,000	
Overhead	2,000	
Depreciation — fixtures	1,000	
Depreciation — building	1,250	<sup>2</sup>
Delivery expenses	3,500	<sup>3</sup>
Telephone	400	
Interest	2,000	
Advertising	2,000	
Delivery vehicle repairs	750	
Bad debt expenses	750	<sup>4</sup>
Rent	nil	<sup>5</sup>
Business taxes	400	
Realty taxes	<u>800</u>	<sup>6</sup>
Total Operating Expenses		<u>48,850</u>
Profit before Taxes		<u><u>21,150</u></u>

#### NOTES:

1. Owner no longer has a landlord to pay heating and upkeep on premises — business must now pay.
2. Building depreciated (\$35,000 over 20 years) over the length of the loan.
3. Delivery expense increases because of increased business.
4. Bad debt expense increases because more credit given.
5. Rent no longer paid (loan payments not an expense but interest is).
6. Realty taxes now payable because business owns property.

## CONCLUSION

Forecasts are necessary for the successful small business. For almost every business, a forecast is required. If a formal forecast is not prepared, decision-making on all future activities — an increase in ordering of inventory, the purchase of equipment and supplies, the hiring of people, the plans for expansion — will be undertaken piecemeal. This will result in no overall vision and will have a high potential for error. By preparing a forecast, actual results can be compared to the forecast on a monthly or quarterly basis and problem areas can be quickly identified.

## 2. FORECASTING FOR A NEW BUSINESS

*"Forecasting is more difficult without past records, but a new business still needs to forecast."*

— CASE Counsellor

INTRODUCTION .....	18
DOES A NEW BUSINESS NEED A FORECAST? .....	18
WHAT INFORMATION IS NEEDED FOR THE FIRST FORECAST? .....	20
THE FIRST FORECAST .....	22
CONCLUSION .....	26

# INTRODUCTION

In our previous chapter, we examined the concept of forecasting and related it to the existing business. We saw the benefits of past financial records and saw how, to a considerable degree, they were the basis for preparing a forecast. But how does the new business forecast when it has just begun operations and has no past financial records? What about the new business that has not begun operating — how does it prepare a forecast?

The purpose of this chapter is to show the need for a new business to forecast, to examine the difficulties facing the new entrepreneur when called upon to estimate the future, and to provide some pointers in putting together the first forecast.

## DOES A NEW BUSINESS NEED A FORECAST?

A forecast is one of the most useful tools the entrepreneur has in planning the future course of his or her business. For the new business that is just about to start, or for the entrepreneur who is wondering whether or not it makes financial sense to start a new business, preparing a forecast can be considered mandatory.

Basically, there are two reasons for preparing that first forecast:

1. To ascertain for yourself if the business venture will be viable; to visualize your business on paper so as to determine if there are any weaknesses, and to find out if there will be a profit and what the probable amount will be.
2. To demonstrate to a lender and/or outside investor that your new business venture is sound and that any monies put into the business will not be lost. The lender will want to be assured repayment with interest and the investor will want to be sure that there is a good return on investment.

The need for a forecast can be clearly shown in the following situation:

David Miller has been a first class mechanic for over fifteen years. He has spent ten of these years working at a large dealership on Main Street. David has always had an affinity with cars, especially English and foreign sports cars. In fact, the sole reason why so many customers who own foreign sports cars are coming to the dealership is because of David's expertise. Another factor is that there is no top quality foreign car service available in the town.

This has made David Miller realize his importance and has given him the idea of opening his own garage specializing in sports cars. He has some savings, but feels it will not be enough, so he approached a very good friend, Jim Banes.

"I tell you," said David, "we can't lose. Look at the number of foreign sports cars in the area. And don't forget what happens during the summer when all the tourists pass through. There's nobody specializing in repairing these cars."

"I know what you are saying is true, but how do we really know we can make a go of it?" asked Jim cautiously.

"Look, we'll buy that closed gas station just outside of town. It's going cheap. We'll get rid of the pumps, put in two pits in the bays, buy some equipment, get some supplies and some stock..."

"Wait a moment," interrupted Jim. "I'm not putting any money in until I know how much money I'll make; especially in the first year and then for the next five. How do I know I won't make more by keeping my money in five year Canada Savings Bonds?"

David was exasperated. He knew he'd make a go of it, but how was he going to show Jim how much he'd make each year? David decided to go to the bank manager whom he'd known for over 15 years.

"Sorry David," said the manager. "I can't tell you now if we'd loan you the money. I must have some statements from you first — an estimate of what your business will do."

"I don't understand," replied David. "I'm not in business yet. How can I tell you how much I'll make each year in the future?"

The bank manager explained to David how to prepare a forecast. This explanation can be found in our previous chapter. Though acknowledging the difficulty in preparing a forecast without any previous financial records, he showed David that preparing a forecast for the new business was not an impossible task. Let us see what information is needed for the first forecast.

## WHAT INFORMATION IS NEEDED FOR THE FIRST FORECAST?

To start a business, you will, of course, need money — your own and/or outside funding. But after financing the start-up costs, the new business must, on its own, generate sufficient profits to support itself and, ideally, to grow. This is the purpose of your first forecast.

Precisely because you don't have a financial history, it is essential that you gather all the information and data that applies to your first year of operation. Finding the answers to the following questions will help give you the information that you need for your first forecast.

**Market** Who will your customers be? The type of business you are considering will, in part, determine the answer to this question. If you are thinking of a fishing camp, your market will be the angler. If you want to make widgets, you would need to know who uses them. In the case of the widget manufacturer, for example, additional questions arise from the initial question: Is the market for widgets growing or contracting?

If your widget is superior in say, wearing qualities, a further question might be: "Will a longer-wearing widget be attractive to these customers?" The longer-wearing widget may be of interest to the users. On the other hand, though, you might find that your possible customers are not interested in a longer-wearing widget, since they are more expensive than those they now use, and because the existing type of widget lasts as long as the equipment in which it is used. It might not make sense for prospective customers to purchase a product they do not really need.

Where are the customers located? This may affect your decision on location of the business, advertising, and how many salesmen to employ.

How will the customers order? Will they order regularly or irregularly and will they place a few large orders or several small ones? What will be the frequency of rush orders? Answers to these questions will affect your inventory requirements, the scheduling of production and possibly the number of employees you will require.

**Prices** What are the prices of competitive products? Do these include freight costs? Are discounts given by competitive businesses? What price structure do you need in order to make reasonable profits?

**Material** What will be the cost of the materials you need? How well established are your suppliers? What is their reputation for quality, service, and delivery?

**Competition** Who are your competitors? Are they large or small companies? How are they likely to respond to your company's entry into the widget-making business? Are they likely to reduce the price of their own product, improve service, or develop their own longer-lasting widget in response to your possible threat to their business? How long might it take them to develop such a widget? In other words, how much time do you have to become an established widget supplier? Could you still compete effectively if competitors were to take a run at you? Can they afford to do so? How many widgets can you sell and at what price?

**Facilities and Equipment** What kind of facilities do you need? What are the costs of facilities and equipment? What are the relative costs of leasing and purchasing facilities and equipment? Is adequate equipment available? When, and under what conditions (warranty, delivery, etc.) can it be obtained? What are the reputations of the various manufacturers of the equipment?

**Employees** What skills will your employees need? If you have decided on a location where you would prefer to establish your business, is there an adequate supply of possible employees with the required skills? Can these skills be readily taught? Is there a training facility in the area or will you have to do the training yourself? What wage rates and benefits will you have to pay? What relationship do other businesses in the area have with their employees? Will you pay by the hour or on some other basis, for example, piecework?

**Production Costs** How much will the material to make a widget cost? Is there any difference in material costs for different numbers of

widgets produced? What will power cost and how much will be needed to operate your equipment, and heat and light your facilities? How many widgets can an employee produce? How many widgets do you need each employee to produce to sell the volume expected? What regulatory authorities will you have to deal with? What are the regulations you will have to obey? How much will complying with these regulations cost?

**Financial** What kind of record-keeping system should you have? Will you need a bookkeeper or a full-time accountant? If you need to borrow money, can it be obtained? What terms will you get?

**Working Capital** What inventory level will you need in raw materials and finished products? What is the amount of accounts receivable you can expect to have on your books at any one time? What payment terms would apply? What are the payment terms of your suppliers? How long would it take for the purchased material to be sold as finished products? What proportion of your sales would be for cash or immediate payment? Is additional working capital available if you need it?

These questions are by no means intended to be an exhaustive list. However, having answered them should put you in a better position to prepare your first forecast.

## THE FIRST FORECAST

How does the new business with no past financial history prepare its first forecast? As we know, a forecast entails the following calculation:

$$\begin{aligned}\text{Sales} - \text{Cost of Goods Sold} &= \text{Gross Margin} \\ \text{Gross Margin} - \text{Operating Expenses} &= \text{Profit}\end{aligned}$$

Let us look at each calculation individually.

**Sales** This is the most important figure to calculate realistically. An error in your estimate of sales, especially if on the high side, could lead you into business without the ability to show a profit.

The new business is translating its estimated share of the market into a dollar figure. Yet, at the same time, this figure must bear a relationship to cost of goods sold. If you are a new manufacturer, your estimate

of sales must not exceed your capacity to produce finished products and must take into consideration the time required to actually produce the finished products. In other words, you must first have something to sell.

For the retailer, the ability to purchase inventory must be in direct relationship to the amount of sales and the factor of stock turn-over. For the service business primarily selling a skill, the factor of time must be recognized.

Estimating sales is difficult for the new business. A high priced item means that your sales figure is probably derived by multiplying the number of items you estimate to sell by the selling price. A large variety of products with a low price will mean the sales figure is determined on a volume basis. The selling price itself can be difficult to establish; though in most cases it will have to be primarily based on your competitors' prices and may only marginally reflect your own needs and circumstances.

**Cost of Goods Sold** Forecasting how much your product costs will naturally depend on how much you intend to sell and what inventory levels you will have. As with sales, if your product is high-priced, your cost of goods sold can be calculated by multiplying the product's cost by the number of items you intend to sell. If your product is low-priced, your cost of goods sold will be calculated in relationship with your inventory levels. For example, you take your beginning inventory and add to it the purchases you intend for that period, and the result is your goods available for sale. When you subtract your ending inventory from goods available for sale, you have your cost of goods sold.

Cost of goods sold will reflect the factors of: time, ability to purchase and carry inventories, stock turn-over, and the ability to manufacture. Again, it is important to stress the relationship of cost of goods sold to sales.

**Gross Margin** Calculated once you have determined your sales and cost of goods sold.

**Operating Expenses** Estimating your operating expenses is one of the most difficult things to do when you have no past experience on which to rely. Regardless of how thorough you are in estimating general and administrative expenses, chances are that you will run into more ex-

penses than anticipated. For this reason it is crucial that in the first forecast you calculate a 10 to 15 percent contingency for unaccounted expenses.

**Profit** Once you have arrived at an operating expense figure, your profit is calculated by subtracting your operating expenses from your gross margin.

**Note:** Statistics Canada and other trade associations have available average percentages of cost of goods sold and various expenses for a large number of retail and manufacturing businesses. This can be helpful as a guide in preparing the first forecast.

Your forecast, if realistically done, should indicate if there is enough profit to meet your needs and provide for any scheduled debt repayments. It is important that, if your forecast shows an insufficient profitability, you do not simply revise it. Check that all your estimates are accurate. If they are, you will have to seriously consider the implications of proceeding with your proposed new business or make major modifications if you have just begun.

A first year forecast may look like this:

**David Miller**  
**Sports Car Speciality**  
**First year forecast**

Sales		\$96,000 <sup>1</sup>
Cost of Goods Sold		<u>58,000 <sup>2</sup></u>
Gross Margin		38,000
Operating Expenses:		
Wages — part-time clerk	\$ 8,000	
Salary — owner	10,000 <sup>3</sup>	
Overhead	800 <sup>4</sup>	
Depreciation — fixtures	1,500	
Depreciation — building	1,300	
Garage expenses	3,000	
Telephone	300	
Interest	1,800 <sup>5</sup>	
Advertising	500	
Bad debt expenses	300	
Business taxes	250	
Realty taxes	<u>400</u>	
Total Operating Expenses		<u>28,150</u>
Profit before Taxes		<u><u>9,850 <sup>6</sup></u></u>

**NOTES:**

1. Sales estimated as follows: The garage has two bays equalling three customers a day for a daily average of \$500 in sales. To be conservative, the owner allows one day a week to average out as no revenue earnings. Therefore, \$8,000 a month is estimated in sales.
2. Cost of goods sold includes owner's time as a mechanic and one other full-time mechanic. Mechanics' wages including fringe benefits are \$10.00 an hour; therefore, \$140 a day. Cost of goods sold also includes cost of parts used in repairs.

3. Owner draws a salary in addition to the wages he pays himself as a mechanic.
4. Light, heat, and power expenses that are not applicable to the cost of goods sold calculation are shown as overhead. An example of this is the portion of the expenses applicable to the office in the garage.
5. Miscellaneous operating expenses such as consumable supplies not directly attributable to the repair of a customer's car are entered here as garage expenses.
6. A loan was taken out to finance the purchase of the garage and the start-up. This is the interest payable, not the principal.
7. Profit before taxes should not be confused with the actual funds available to the business. Actual funds means profit less estimated income taxes plus depreciation. These actual funds can be used for debit retirement, inventory build-up, etc.

## CONCLUSION

At the outset, the new business will always be faced with the risk of failure. The preparation of a forecast will not eliminate this risk. Rather, the forecast can provide some further insight into the possible risks involved and provide you with a more informed basis on which to judge them. It can reduce the number of surprises that might lie ahead for your business.

### 3. CHANGES OF OWNERSHIP

*“The buying and selling of a small business can be a complex process. But careful planning and a clear understanding of the process will lessen the complexity.”*

— CASE Counsellor

INTRODUCTION .....	28
SELLING A SMALL BUSINESS .....	28
Setting your price .....	28
How to determine your asking price .....	29
Attracting prospective buyers .....	30
Prepare your sales pitch (in writing) .....	31
BUYING A BUSINESS .....	32
Contacting the seller .....	33
Verifying the information .....	34
The asking price — if high, why? .....	35
Measuring a business’s profit .....	36
The business’s worth from the buyer’s perspective .....	37
Negotiating the sale .....	39
Concessions you can offer .....	39
Making your offer .....	40
CONCLUSION .....	41

# INTRODUCTION

A change in the ownership of a business has all the components of the simplest marketplace activity: a product, a seller, and a potential buyer. But the selling and the buying of a business is also one of the most complex. Why? Because the seller's price tag on a business is usually more than the value of the business's tangible assets — those assets that can be seen and touched. The difference between the price tag and the assets of the business is an intangible commodity called goodwill.

How does the seller put a price tag on this intangible goodwill? How does the buyer know that the evaluation is a true one?

This chapter is about value: the value of a business to the seller, and the value of a business to the buyer. It also examines how the value of a business is determined so that it is agreeable to both parties. Without this agreed value, there can be no go-ahead for a change in ownership.

## SELLING A SMALL BUSINESS

Let us assume that you are the owner of a small business that you have built from scratch and, for personal reasons, you wish to sell it. Where do you start?

You start by establishing a price for the business. There is no point in advertising its availability unless you have a price in mind. A ballpark figure will not excite a prospective buyer any more than a price tag on a piece of merchandise that reads, "Between \$150 and \$200".

### 1. Setting your price

As a seller, you must forget about your past investment of time and personal money, and base your price on present and future factors. Potential buyers are interested mainly in the ability of the business to yield a fair return on their investment after they have drawn a reasonable salary from its income. They will be interested in the immediate and long-

term potential of the business to determine if it will yield a return on investment equal to, if not better than, alternative investments.

If the business has a limited potential for growth, the prospective buyer will not likely offer you more than the value of the tangible assets (those assets that can be touched, weighed, or measured) which could then be resold on a piecemeal basis. The buyer would not ascribe any value to goodwill which, in a very real sense, is directly related to the earning power and potential of the business.

## **2. How to determine your asking price**

You can determine your asking price by proceeding as follows:

- (a) Establish the tangible net worth of the business (that is, assets less liabilities, ignoring any intangible assets such as goodwill).
- (b) Estimate what dollar return — perhaps 10% — an investor would get on this amount if invested elsewhere with approximately the same degree of risk. This is called earning power.
- (c) Add a reasonable salary for the new owner.
- (d) Establish from the operating statements the average annual net earnings before taxes (net profit before deducting owner's drawings) for the past few years. This gives a means of comparing the historical earnings with those the prospective buyer could get from alternative sources open to him. The trend of historical earnings is the key factor.
- (e) Deduct the earning power (b) plus reasonable salary (c) from the average net earnings (d) to determine the business's extra earning power.
- (f) To value the intangibles, multiply (e) by the number of years of profitable operation. A well-established and successful business would justify using a factor of five or more; a less well-based enterprise might suggest a factor of three as appropriate.
- (g) Final asking price — tangible net worth (a) plus value of intangibles (f).

Here's how the price formula can be applied to two businesses up for sale.

	Business A	Business B
(a) Tangible net worth	\$40,000	\$40,000
(b) Earning power — 10% of (a)	4,000	4,000
(c) Reasonable salary for owner	10,000	10,000
(d) Average net earnings	16,000	12,000
(e) Extra earning power (d) minus (b) and (c)	2,000	—2,000
(f) Value of intangibles (e) times 5	10,000	nil
(g) Final asking price (a) plus (f)	<u>\$50,000</u>	<u>\$40,000</u>

In the case of Business A, the seller should get a substantial price of \$10,000 for the intangibles (goodwill) because the business is well established and is probably earning more than the potential buyer would likely get elsewhere with comparable effort and risk. The buyer would, in this example, recover the cost of goodwill (f) in five years. The reasoning is that if the business continues to average \$26,000 net earnings per year, the buyer will realize his 10 percent return of \$4,000, his salary of \$10,000 plus \$2,000 extra earnings each year. This last amount would equal, in five years, the \$10,000 he paid initially for the goodwill.

For Business B, there is no goodwill value because there is no extra earning power (e) and a prospective buyer might even conclude that the business was not worth its tangible net worth (a) because of the poor return on an investment of that size. Intangible assets often include patents, franchises, organization expenses, and trade marks as well as goodwill.

### 3. Attracting prospective buyers

Having set a price that you feel reflects the business's present and future value, you can attract prospective buyers in one or more of the following ways:

**Word of mouth disclosures** Informing your suppliers or business associates might bring you nibbles, but there will be few serious bites unless you know of a party who has previously expressed interest in owning your kind of business.

**Classified newspaper advertising** This medium is inexpensive and effective providing the ad specifies price, location, size of business, and potential sales volume. You should decide in advance if you wish inquiries to be made by telephone or mail.

**Real estate brokers** Though you must pay them a commission, they have their finger on the pulse of the market. They will screen prospective buyers and will ensure that all the proper legal steps are taken.

**Trade publications** These are effective in reaching prospects already active in the kind of business you are selling.

## 4. Prepare your sales pitch (in writing)

To illustrate why you as a seller should be prepared, let us look at the following story:

Glen Harvey, after almost twenty-three years in business, decided to sell his hardware store. It was a difficult decision but the reasons were personal and involved his only son who had decided neither to work in the store nor to become a partner. So Glen placed a number of ads in the papers, and waited.

The first serious enquiry that Glen received went something like this:

"You're asking \$110,000 for the shop?" questioned the man holding the newspaper. "I think that's high."

"Oh no," countered Glen. "There's a lot of business done from this shop. I've really established a good clientele."

"Can you prove it?"

Glen produced a set of financial statements.

"These are last year's statements," observed the enquirer. "Plus this is just the balance sheet. I want to see current operating statements plus statements for as many years back as possible."

Glen scratched his head. "I'll have to see my accountant. But in the meantime look around the place."

The man asked Glen a lot more questions and Glen found himself constantly saying that he'd get the figures or speak to his accountant. The enquirer was constantly asking for proof and was belittling the price that Glen was asking. He even expressed disbelief at Glen's answer of personal reasons for selling.

"I might be back," announced the enquirer. "But there are a couple of other places I want to look at first."

The door closed on Glen. He was perplexed. He knew the price was a fair one but how was he to prove it?

Just as Glen advertises and promotes his products, he should do the same when selling his business. Serious prospective buyers will ask for written documentation describing a business's past performance, present level of business activity, and future growth prospects.

The package of material that should be assembled should include:

- a brief history of the business from its incorporation to the present, and an estimate of its growth potential
- balance sheets and operating statements for the previous years, and an interim statement
- a written statement setting out the basis of establishing and evaluating the asking price

## **BUYING A BUSINESS**

So you have weighed the pros and cons between starting a business from scratch and buying an existing one, and have decided to buy. Where do you begin?

The same methods that the seller uses can be your starting point:

**Word-of-mouth disclosures** People such as suppliers, bankers, Board of Trade members may tell you about particular owners who are thinking of selling. Further enquiry might prove such disclosures to be rumours, but it could lead to a genuine prospect.

**Classified newspaper ads** They give a capsule description of the kind of business that is for sale, the reason for sale, and often a ballpark price that represents a point from which you can negotiate. Steer clear of ads that promise “fabulous profits to be made in the fastest growing business in the ‘80s” or “once in a lifetime opportunity to cash in on the bonanza.” If such businesses really do yield fabulous profits, they don’t need this kind of flamboyant advertising.

**Real estate brokers** When describing a business for sale, brokers will tell you more about the tangibles such as the plant and equipment, than about the intangibles. But through them you can arrange to visit the current owners.

**Trade publications** These can be ideal for finding out which businesses are for sale and where they are located. One drawback is that because of the time it takes to publish, advertisements are often for businesses that were sold just prior to, or just following the publication’s release.

## 1. Contacting the seller

If you see an advertisement for a business that appears attractive as an investment, or you hear of such a business that is about to be put onto the market, make your first contact with the owner by telephone. Ask questions that elicit information such as “If you had the capital, how would you expand your business?” If the owner sounds doubtful about the business’s potential for growth, ask why. You should know. Jot down all the information the owner reveals about the business, then arrange for an appointment. Before the meeting, visit competitors, check available products and prices, check suppliers’ prices, and visit the business incognito to get a feel for the premises especially if it is a restaurant or a shop. Pretend you are a customer and note the morale of the employees. When you pay a formal visit, ask the owner to provide you with

documentation, such as financial statements, photocopies of the lease if the business is in leased premises, and sales promotion brochures describing the business's products or services.

## 2. Verifying the information

If there are trouble spots in the business, the seller is not going to alert you to them. Like a doctor examining a patient, you must examine the business to determine its state of health.

Carefully check the following:

**The owner's reason for selling** The seller might want to retire, but why? Is this because he or she is near retirement age, or is it because the demand of the business on the owner's time and energies is exhausting? Find out.

**The seller's financial statements and records** They may indicate the owner's real reason for selling. Verify them against tax returns.

**Operating documentation** This includes the calculation of costs of goods sold, sales, and operating expenses. It also entails the pricing structure and rate of inventory turnover. You can check some of this data with suppliers. Compare productivity with similar businesses. Confirm prices and sales patterns.

**The value of the tangibles** This means the equipment, premises, and inventory. Compare their value with the costs of starting from scratch.

**The value of the intangibles** Can the monetary value that the seller applies to the intangible assets — the business's reputation, regular clientele, and potential for earning a better than average profit — be justified?

**General conditions** Get a feel for employee morale, the bustle created by customers and the competition. Are there too many businesses competing for a diminishing market? Is the surrounding area becoming more or less prosperous? Do government regulations help or hinder you in the kind of business you wish to enter?

If in doubt about certain results of your research, consult an expert. Better to pay a little for good advice than to pay a lot for your bad judgment.

### **3. The asking price — if high, why?**

The seller is entitled to set an asking price that allows room for manoeuvre once bargaining begins. Why might an asking price seem unreasonably high? There can be a number of reasons such as:

- The current owner includes his or her salary in profits, or draws an unrealistically low salary for time and skills input, thereby inflating profits.
- The owner doesn't pay interest on the capital that he or she has put into the business. This inflates profits.
- The current owner doesn't worry as much about future risk as the potential owner.
- The current owner has an emotional attachment to the business. The evaluation is based on a distorted sense of the business's reputation among its clients.
- The current owner needs the amount of the asking price to finance the planned retirement or next business venture.
- The current owner has been led to expect a high offer by an enthusiastic broker looking for a listing, by reports of other business sales, or by encouragement from family members.
- The current owner wishes to recoup the losses in time and money put into the business in its first years of growth.
- The current owner's asking price is based on a too optimistic earning potential. "Population is due to double in the next five years", the owner might assure you. That might be true; but the competition, property assessments, and taxes may also double.

If the asking price seems unreasonably low, don't dismiss it as a losing proposition. It could be a genuine bargain if:

- Earnings have been low due to poor management that you can rectify.

- The current owner **has** to sell. A due to illness sale could mean just that.
- You can get improved economies of operation by combining the business with another venture.
- The owner fails to appreciate the true value of the business, perhaps due to valuing assets at their original cost or even the depreciated book value.
- The alternative of starting from scratch is not as feasible due to present market conditions.

## 4. Measuring a business's profit

The owner of a business can receive financial benefits from his or her business in three major ways: by earning interest on a personal loan to the business, by drawing a salary, and by earning a profit. How do these three ways affect the goodwill?

**Interest** The owner may loan money to the business rather than borrow at a bank. If so, the owner should receive interest on these loans, equivalent to prevailing rates. This is an expense, and will reduce true profit. Owners who make low interest or interest-free loans give the business a false profit picture.

**Salary** The owner who works for the business should draw a fair salary and range of benefits. These are expenses which will reduce the profit figure. Often owners don't draw a fair salary for the time and energy they put into the business, or pay salaries to their relatives who help in the business. Then there are owners who pay themselves too much and claim expenses which are really personal benefits. This gives an equally false profit picture to a business. It is up to you to discern the real salary.

**Profit** This is what is left over after deducting expenses (including the owner's salary), and it can be the most arbitrary of the three owner's earnings. Here are three examples of just how arbitrary it can be.

Tom loans the business his own \$20,000 with no interest charges, and pays himself a nominal salary. Dick borrows his \$20,000 from a bank and draws a fair salary for his role. Harriette draws as much as she can in

salary, borrows \$30,000 from the bank so she can buy a car for her personal use, and pays for travel and entertainment expenses through the business.

	Tom	Dick	Harriette
Revenue of business	\$100,000	\$100,000	\$100,000
Salary	12,000	20,000	24,000
Bank Interest	nil	2,500	3,600
Other Expenses	<u>70,000</u>	<u>70,000</u>	<u>79,400</u>
Profit or (Loss)	\$ 18,000	\$ 7,500	\$ (7,000)

Is Tom’s business really more profitable and hence worth more? No, he is just understating his true expenses. He should pay himself interest on the loan and draw a more realistic salary. Is Harriette’s business really a losing operation? No, she’s just using it to pay for lifestyle benefits that she hasn’t earned.

Note that all three businesses are the same, but profit is calculated in three different ways.

Profits for the immediate future should also be considered. One expense that is often ignored is depreciation on capital assets. This is particularly important if the seller wants to sell you the assets at more than their book value. You will have to claim a higher depreciation expense, thus reducing profit. Also check for major expense increases such as rent, insurance, renegotiated equipment leases, etc., which will affect the profit picture in the coming year.

### 5. The business’s worth from the buyer’s perspective

Just as the seller has assigned a dollar value to the tangible and intangible assets of the business, you must also do the same. Estimate the value of:

**Equipment and furniture** Major items should be valued at the going market price for used equipment in similar condition, less a fraction to allow for the fact that they would be sold as a bulk lot.

**Supplies and small items** Some supplies are virtually unsalable except to the buyer of the business, and therefore have little value. These would include open containers of supplies, printed stationery, Christmas decorations, and similar.

**Inventory** Inventory is generally valued at cost except for old stock which has not moved well, or has become outdated and will therefore sell for even less. You should not pay for unsalable items. Consider using the services of an independent appraiser to arrive at an objective estimate.

**Leasehold improvements** If the seller has made necessary improvements to the premises or site which are not reflected in the rent, this has some value, but you must write it off as an expense during the duration of the current lease. But don't allow for the entire cost of the improvement because the vendor hasn't the choice of selling the improvements to a party other than the buyer of the business.

**Accounts receivable** As a rule, the buyer doesn't take these over. But if you agree to, discount them to allow for the risk of possible bad debts and the cost of financing. A simple listing of these accounts by age can help you determine what they are worth.

**Goodwill** In one sense, goodwill includes the intangibles such as the business's reputation and regular clientele. In another sense, it is the ability of a business to earn better than average profits. It can be the result of good management, an excellent location, a special process, or a patent, etc. If the business earns more than the 12 or 15 percent that you could expect to earn on another investment, then you will likely have to pay a premium to buy this earning power. That is what you buy when you pay for goodwill.

Goodwill is measured in multiples of true profits. Whether you use a small multiple or a large one depends mainly on the element of risk you expect. A long-established business with stable earning power might sell for a low one. Basically, the multiple reflects how quickly you want your investment repaid. The greater the risk, the quicker you want your money back.

Totalling the preceding six items will give you an approximate estimate of the worth of the business. Let the total represent your final price offer. Initially offer less. A business is worth no more than the high-

est price someone will pay, and no less than the lowest price the seller will accept.

## 6. Negotiating the sale

The handshake price isn't the only negotiable item when buying a business. You negotiate a package deal which could include:

**Vendor financing** The seller might provide financing. If so, agree to terms such as the down payment, interest rate, duration, and collateral.

**Pre-disposition of certain assets** If you don't want the company car included in the deal, ask the seller to dispose of it in a separate sale to another buyer.

**Price allocation for tax purposes** As a buyer, you will want the highest possible expense amount (fees, interest, supplies, inventory); the highest possible valuation of depreciable assets (equipment, small tools, leasehold improvements); and as little as possible for goodwill. The seller will want the opposite.

**Fees to the seller** The seller might ask for a consulting fee during the change-over, or a percentage of future income.

**Noncompetitive agreement** The goodwill you pay for will count for nothing if the owner sets up a new business across the street and takes away the customer base that comes with the business. Draw up an agreement to ensure that if the former owner does set up another business, it will be remote from yours.

Before entering into negotiations, consider these factors, and be prepared to trade some of them for concessions you will want from the seller.

## 7. Concessions you can offer

As part of the purchase package, you might offer some concessions which might appeal to the seller, yet be advantageous to you. They could include:

- An agreement to work for the seller for one month prior to the change-over. For this free or minimal paid labour, you will get invaluable training.
- A higher offer if granted a lower interest rate or other favourable financing terms.
- Paying consulting fees for a year or two as part of the price. This is, in fact, an interest-free, unsecured loan to you. You can write it off as a full expense. For the seller, it might spread the taxable gains over several years.
- Repayment in the form of balloon payments. These are large amounts paid at annual periods rather than monthly.
- A percentage of next year's gross as part of the price, up to a specified limit. The seller has the hope of getting more if the business does, in fact, have excellent growth prospects. You are protected in case things don't go well. It's also an interest-free loan.
- Pay part of the price as a consulting fee to a relative whose income tax bracket is lower than that of the seller.
- Pay the seller a commission for a year on any new accounts that he or she brings in. Give a discount to the seller on personal purchases.

## **8. Making your offer**

Before you sign an offer, protect yourself with the inclusion of some escape clauses, usually referred to as subject clauses, such as:

- subject to buyer obtaining financing on satisfactory terms
- subject to vendor making all records available to buyer and/or accountant for full inspection and verification
- subject to buyer's lawyer approving the terms and form of agreement
- subject to buyer having the opportunity to view operations in detail, and time to verify and supplement information presented to date

- subject to buyer receiving necessary licenses, permits, registrations, etc., including use of existing premises as is (i.e. no improvements required to satisfy health codes, etc.)
- subject to property owner approving sublease to buyer
- subject to equipment, leases, debts, etc., being transferred to buyer

You should keep these subject clauses general. They usually have a time limit during which you must remove them or else the agreement becomes invalid.

Your offer should also allow for price adjustments for items likely to change before you assume ownership. This would include a reduction or increases if the inventory is different from that noted in the seller's list of current assets. Set a maximum figure for such items. Adjustments for expenses prepaid by the vendor or for income received in advance, such as deposits, should also be included.

## CONCLUSION

Setting a value on a business is the major problem encountered when the ownership of a business is about to be changed. There are two values inherent in the same business: the value to the seller, and the value to the buyer.

The value of the tangible assets can be mutually agreed to because they are measurable by objective standards. The value of the intangibles, mainly goodwill, is subjective. But to allow a change of ownership to take place, there must be an agreement between the seller and the buyer as to both values.



## 4. PRESENTING YOUR CASE FOR A TERM LOAN

*"Regardless of where you seek term financing, each lender will require basically the same information."*

— CASE Counsellor

INTRODUCTION .....	44
WHAT IS TERM FINANCING? .....	44
WHY PRESENT A CASE? .....	45
WHAT DOES A LENDER WANT TO KNOW? .....	46
WHAT PAPERWORK MAY BE REQUESTED? .....	51
CONCLUSION .....	53

# INTRODUCTION

What information would you want to know if you were asked to lend your money to someone for several years? Probably quite a lot for you would want to be sure that your money would not only earn interest but that it would be a safe investment. So when your business needs a term loan, remember that you, too, will be asked for information. This information constitutes presenting a case for a term loan.

This chapter introduces you to the concept of term financing. It looks at the need for presenting a viable case for a loan, and, as well, examines what information and paperwork a lender will want.

## WHAT IS TERM FINANCING?

Term financing is a definition used to describe the borrowing of money in which the repayment takes place within a certain period of time, or term. Term financing, or debt financing as it is sometimes called, is often defined by its terms of repayment: **short-term**, **intermediate-term**, and **long-term**.

**Short-term financing** Generally extended to a business for one year or less. These loans are obtained to meet working capital needs such as operating expenses, seasonal slack periods, and inventory build-ups. Short-term loans may also be used for an interim period while arranging longer term financing.

**Intermediate-term financing** Used for periods of more than one year but usually for less than five years. This financing provides monies for other than temporary needs. These needs can include the starting of a new business, the buying of an existing one, the expansion of operations, the purchase of assets, or for leasehold improvements.

**Long-term financing** Financing for a period exceeding five years. Usually, the purpose of the loan is to purchase a high value asset such as a building or land.

In defining a term loan, it is important to know that this type of financing has particular characteristics:

- the interest rate at time of borrowing is slightly higher than other types of loans
- normally there is a fixed interest rate for a specific period of time — payments stay the same
- often, the loan is secured by fixed assets
- time length of loan is specific and agreed upon
- the loan may take time to obtain

## WHY PRESENT A CASE FOR A TERM LOAN?

Before examining the information and the accompanying paperwork that a lender will require, it can be helpful to really understand the need for presenting your case for a term loan. Let us look at the following situation:

"Well, do you at least have an idea of how much money you need?" asked the loan officer.

"Oh yes," replied Paul. "We need \$45,000."

"Yes, that's the amount," interrupted Paul's partner Eric. "But to that figure you must add \$12,000 for buying the used tow truck."

"Just a moment now," said the loan officer. "The two of you, as partners, want to open a service station, right?"

"That's it," said Paul, "and we need a loan to get started. We can put up almost \$15,000 cash of our own money."

"Is that \$15,000 part of your \$45,000, or rather \$57,000, requirement?" asked the loan officer.

"We're using the \$15,000," replied Eric. "The \$57,000 is the money we still need."

"Have you thought about how you will pay back the loan?"

"Yes," answered Paul. "We should be able to manage the payments."

"But what about your other debts? Listen, you say you have a great idea for a business but you can't expect to get financing by just saying that you have a good idea. There's information and paperwork that I need. This can be summarized as knowing: who you are, what you plan to do, and what will happen once you get the loan.

"I want to know your financial background to see if there's any additional financial support in case your business gets in trouble. I need financial statements for your proposed first year in business.

"This will show me the anticipated operation, your anticipated sales and profits, and why you need the loan.

"I also need a cash flow for your first 12 months. This shows if the loan amount is justified and if you will have any problems in meeting your operating debt and also paying back the loan. Then, there is the question of security..."

"Wait," interjected Paul. "Do you really need all that information?"

"Yes — you must not only prove to me that any money I invest in your business will earn interest and be safe, you must also prove it to yourself that you can make a go of it."

A well thought out and prepared presentation will go a long way in helping both the new and existing business sell itself for a term loan. Remember, the supply of money can be tight at times and, at all times, you are in competition for the same financing monies.

## **WHAT DOES A LENDER WANT TO KNOW?**

The purpose of our story about Paul and Eric was to illustrate why a lender needs information and paperwork. The question that next follows is what information will the lender need when considering your presentation for a term loan.

The loan officer in our story summarized the information as: **who you are, what you plan to do, and what will happen once you get the loan.** As well, he added the aspects of **security** and **financial strength**.

## 1. Who you are

This question applies not only to yourself as the owner but also to the business itself. The quality of management in your business is of utmost importance. Explaining who you are gives the term lender an idea of what to expect from the management of your business. Of interest to the lender is: your education, your experience (or lack of it), your accomplishments, your shortcomings and who on your management team can compensate for them. Write these facts down. Term lenders can also compare, from their own experience, the relative strengths of your management with many other businesses, particularly those in your industry. Obviously your diligence and determination to be a success will also be major factors. No management group in a small business is likely to appear perfect to an outsider. Discussing your business with a term lender may sometimes lead you to make improvements in your organization that may eliminate possible future problems.

Of greatest single importance to most lenders, and naturally to you, is the ability of your business to earn sufficient profits to repay the term loan, with enough remaining funds to meet the normal needs of the business. Without this ability your business will fail. It is for this reason that financial statements are required by the lender so as to demonstrate that your venture is viable.

To complete the picture of you and your business, the lender will also ask for non-financial details of your enterprise such as the history of the business, its growth potential, as well as details of operations and products.

## 2. What you plan to do

To show a term lender what you plan to do, demonstrate your plan and its financing, in the following way:

### PROGRAMME

Purchase land	\$11,000
Construct building addition	50,000
Purchase & install equipment	17,000
Provision for contingencies	<u>8,000</u>
	\$86,000

### FINANCING

Term loan	\$59,000
Additional share- holders' investment	<u>27,000</u>
	\$86,000

This simple presentation can then be expanded with footnotes or attached sheets, giving the details of each item, for example: the size, location and legal description of the land, and the plans for the building addition.

You should indicate clearly which items of the cost are firm, and which are only based on estimates. In the above example, a provision for contingencies of \$8,000 is included to allow for such things as inaccuracies in estimating, items overlooked, and changes during construction that may involve extra cost. The amount that you should provide for contingencies depends on the nature of your programme and the portion which is subject to estimates. Even for the portion which is firm, there will often be changes made while the programme is in progress, particularly where it involves the installation of machinery and equipment. These changes often add to the cost of the programme. In some cases, a contingency reserve of at least 50 percent is desirable even when a large part of the programme is covered by firm commitments. In

the average case, a cost overrun of 10 percent to 20 percent can be expected. A corresponding provision for contingencies at the outset will prevent a shortage of funds when your programme is only partially completed.

It is also important to demonstrate to the term lender that your programme will bring tangible benefits to your business. In the case of a large sophisticated business, with careful control over capital budgeting, it is normal for a lender to require that an analysis be made of what is expected from a particular project by way of decreased costs and increased net revenues. For a small business, without the same degree of sophistication in capital budgeting, such an analysis is difficult to prepare. In any case, there should be some thought given to the potential savings to be derived from the programme. If the main purpose of the programme is physical expansion to take care of increasing sales volume, you must ensure that the expansion is in reasonable relation to the expected sales volume, as there are few businesses that can really afford to have a large amount of unused or excess capacity.

Finally, you must show details of how you propose to finance your programme. Sometimes this will simply be the term loan. In other cases, the programme might involve additional investment by you, or perhaps the use of working capital. In the case of additional investment, a lender will normally want to be assured that this money is available. If part of the financing is to come from working capital, it is helpful to have prepared an analysis of how this can be accomplished without jeopardizing the working capital required for the normal day-to-day financing of the business.

### **3. What will happen once you get the loan?**

The answer to this question is the justification for requesting the term loan in the first place. This is when the term lender will want to know what your financial situation will be like in the future. You will probably have more assets purchased with the new financing. You will also have more liabilities, including the term loan, and perhaps there will be a new investment by you and others.

The lender will analyze your financial future by requesting a pro-forma balance sheet, profit and loss statement, and cash flow. These

statements of the future will be examined to ensure that the amount of new debt will not upset the balance of total debt to owners' investment that a successful business should maintain. They will also show what the business will earn in the years following completion of your plan. In other words, these future or pro-forma financial statements must show that a term loan is needed, that it can be paid back, and that in getting the loan a definite benefit will be derived by the business.

## **4. Security**

Since most term loans are secured by the term lender taking a charge on the fixed assets of the business, it is apparent that the security value of these assets is also a criterion affecting the amount of term financing you might obtain. If the fixed assets of your business comprise only leasehold improvements, which usually have a very low relative recovery value in the event of liquidation, it is obvious that security values would be very low. On the other hand, a mortgage on a well-located, general purpose building of good quality construction, represents very good security. However, many lenders are prepared to make a loan which is under-secured by the fixed assets if the business has excellent earning prospects. Be prepared to describe your land, buildings, machinery, and equipment.

## **5. Financial strength**

Finally, there is the general financial strength of the business now and after your plan is completed. Will there be sufficient capital to meet trade debts promptly, to survive seasonal lulls comfortably, and to maintain good deliveries and service to your customers? Again your balance sheets and profit and loss statements will enable the term lender to make a few simple tests to be ensured of your financial strength.

From this brief introduction on what information is needed by a term lender, we shall next look in detail at the form in which this information should be presented to the term lender.

## WHAT PAPERWORK MAY BE REQUESTED

You will know what your business is all about but the lender will, of course, not know it in the same detail. The lender may even know nothing at all about your business. Because it is to your advantage to prove to the lender that a loan for your business is a wise and safe transaction, you will want to sell yourself in the best manner possible.

The best manner possible means a presentation that is clear, straightforward, and is in a format that can be both examined and referred to again. Naturally, this means paperwork.

Let us look at what paperwork is usually required when presenting your case for a term loan. Not all this paperwork may be requested by every lender, but it is a good idea to know what to expect.

**Resume of the principals** Give a brief background of the owners and key people who work, or will work, in the business. Emphasize why they are valuable to the business. This information allows the lender to assess management abilities.

**Resume of the business** Describe the basic non-financial background of the business. In other words, include such facts as: when the business was started, who started it, why it was started, where it was started, the legal structure, operating and product details, major suppliers, customers, and the advantages the business has over other concerns. In short, this tells the lender what the business is all about.

**Personal financial statements** Often required for a new business situation, especially if the principals have never been in business before. A personal financial statement will show the lender what additional financing is available to the business should it get into financial difficulties.

**Financial statements** These include a profit and loss statement, a balance sheet, and a statement of retained earnings. For an existing business, these statements should be for the last five years or, if less than five years, for as many years as is possible. For a new business with no financial history, statements should be prepared for the proposed first year of operation. This information permits the lender to analyze the financial situation of the business (assets, liabilities, growth, equity, and short-falls). It allows the lender to assess the worth of the business.

**Profit and loss statement for the future** Statements to be done for both the current year and for the following twelve-month period. This tells the lender what the future will be for the business and if the loan can be repaid.

**Cash flow for the future** Done for a twelve-month period and includes the proceeds of the requested loan. This shows the lender why the loan is needed and where any problems in repayment may occur.

**List of securable assets** Useful to the lender if the term loan must be secured. A simple list of available fixed or movable assets should include descriptions of the assets, when they were bought, and the purchase price.

**Leases, mortgages, insurance policies** If the premises are rented, a copy of the lease will show the lender if the business is liable for any penalties in case of default, or is governed by any restrictions from the lessor. Property owned by the business or owner(s) is a major security item. A copy of the mortgage along with evidence of what principal and interest has been paid and details of any liens will be of interest to the lender.

In preparing the paperwork for presenting a case for a term loan, accuracy is crucial. This is especially true in preparing financial statements, forecasts, and a cash flow. You may wish to consider qualified help at this stage. Qualified help should not only assist you in your preparation, it should also ensure that you fully understand your proposal for a term loan.

## CONCLUSION

The information and paperwork that need to be presented to a term lender can be rather imposing. Naturally, if the risk and the amount of the loan is small, the lender's analysis of your presentation need not be as detailed as it would be for a larger loan. The depth of the analysis also depends on the complexity of your business organization, the risk inherent in the particular industry, and many other features. However, the lender cannot make a valid decision on a term loan without considering all these features to some degree. Therefore, being prepared with a well thought out presentation for a term loan will go a long way in proving to the lender, and yourself, that a loan to your business is a good proposition. And remember, if you receive assistance in the preparation of your financial presentation, be sure to understand it as well as possible so as to be able to discuss it intelligently with the lender. This, too, is part of the professionalism required in presenting your case for a term loan.



## 5. Working Capital

*“Working capital is more than the arithmetical difference between current assets and liabilities. It is a reflection of good management if the level is proper for your business.”*

— CASE Counsellor

INTRODUCTION .....	56
THE FUNCTION OF WORKING CAPITAL .....	56
HOW MUCH WORKING CAPITAL? .....	57
WORKING CAPITAL AT WORK .....	58
ESTIMATING WORKING CAPITAL NEEDS .....	61
WHAT IF SALES INCREASE? .....	62
SIGNS OF A POOR WORKING CAPITAL POSITION .....	67
CAUSES OF A POOR WORKING CAPITAL POSITION .....	67
CONCLUSION .....	68

## INTRODUCTION

Expressed in simple terms, working capital is the difference between a business's current assets and its current liabilities. This can be shown by the following equation:

$$\text{Current Assets} - \text{Current Liabilities} = \text{Working Capital}$$

Expressed in another way, it is the amount of working (or current) assets such as cash, inventory, receivables which are **not** being financed by current liabilities such as trade credit (accounts payable) or short-term bank credit.

Working capital is an important indicator of a business's liquidity. It should be sufficient to provide for the payment of current liabilities as they come due, and for the financing of day-to-day operations.

Two typical small businesses will be profiled in this chapter to illustrate the influence of working capital on day-to-day operations, and the influence of those same operations on the business's working capital position.

## THE FUNCTION OF WORKING CAPITAL

Understanding the function of working capital requires an understanding of the relationship between current assets and current liabilities.

Current liabilities are debts which have to be paid in the near future, normally within twelve months. They are paid by the normal circulation of cash through the business. This circulation results from converting cash to inventories to accounts receivable and back to cash. In the case of cash sales, the cycle is even shorter: cash to inventories and back to cash when a sale is made. Because of the mark-up of the inventory, and of the service sometimes sold with the inventory, the amount of cash received from a sale should be greater than the amount spent on the inventory. Therefore, current assets pay for current liabilities.

The ability of a business to pay its current debts on time depends on the amount and timing of this cash circulation from one type of current asset to another: cash to inventory to receivables to cash to inventory, etc. If this circulation is fast compared to the time available for payment of accounts payable owing to suppliers, the business will have cash to pay its debts on time and will have only a minimum of current assets on hand. In reality, most businesses require a working capital surplus, in other words, more current assets than current liabilities. This is because of the need for large, varied inventories which will probably include slow-moving items. Another reason for a working capital surplus is that many businesses offer credit to their customers, which means carrying accounts receivable.

## HOW MUCH WORKING CAPITAL?

How much working capital does a small business need?

The amount of working capital any business needs is determined by:

- the size and kind of inventory it buys (e.g. large and fast-moving such as that of a grocery store, or small and slow-moving like that of an haute couture fashion boutique)
- the amount and terms of its accounts receivable and accounts payable

The above two factors are relative to the business's operating cycle.

There are some analysts who claim that for a business to be truly healthy, it should show a ratio of 2:1 between its current assets and current liabilities. They contend that the need for the amount of current assets to remain at least double the amount of current liabilities is due to the possibilities of shrinkage in the current assets, notably in stated totals for inventories of materials or merchandise. Even if inventories represent sound value, these analysts claim that the inventory will not realize the amount attributed to it in the event of a bulk sale or liquidation.

Ratios, however, are useful only when compared with a reference point. The business owner could compare this year's current asset to current liability ratio with previous years', or with those of other busi-

nesses **in the same line**. Comparisons with businesses in other lines are misleading, and could give the owner undue cause for alarm.

In practical terms, a small business should have enough working capital to maintain good purchasing power so that it can buy its inventory requirements and essential services on the best of terms. Adequate working capital enables a business to take advantage of trade discounts when available, and to keep its costs and prices competitive. The owner who maintains a strong working capital position can insist on prompt delivery of inventory supplies and thus avoid stock shortages or over-stocking. The owner, not the creditors, will be able to direct the business; and its credit reputation will remain high.

## WORKING CAPITAL AT WORK

To illustrate what working capital means, our next sections deal with two small businesses: Leduc Cleaners owned by Bob Leduc, and Drew Drugs owned by Debbie Drew.

Bob Leduc looked at the papers his accountant had just sent him. One sheet, marked Schedule 2, puzzled him. The heading read "Changes in Working Capital between April 1, 1979 and March 31, 1980."

Bob was a dry cleaner and a good businessman. While he had proven his managerial competence by running his dry cleaning shop profitably for nine years, Bob knew he was no accountant. Working capital was a term without much meaning. He had heard his good friend, Debra Drew, talk about it. Debbie ran the drugstore next door. Maybe druggists learned about working capital at college. Occasionally Debbie grumbled that she was short of working capital, even though her busy store never seemed short of anything.

Bob turned back a page. The top of it read:

LEDUC CLEANERS			
Balance Sheet as at March 31st, 1980			
ASSETS		LIABILITIES	
Cash	\$ 100	Bank advances	\$ 3,000
Accounts receivable	500	Accounts payable	5,000
Materials & supplies, at cost	<u>800</u>	Mortgage — current instalments	<u>3,000</u>
Total current assets	\$1,400	Total current liabilities	\$11,000

This seemed easy enough to follow. All of Bob's customers paid for their cleaning with cash, except the supermarket. Their account for dry cleaning of uniforms was the only account receivable. The inventory of materials and supplies was all there in the shop: cleaning materials, rolls of plastic, hangers, labels, cartons. This was not much in the way of current assets, but it was everything that he needed.

Bob's business had a \$5,000 line of credit from the chartered bank down the street. He only used it at certain times during each year and his borrowings had never reached \$5,000. So the \$3,000 owing to the bank was no problem. Accounts payable of \$5,000 looked a little high. Bob decided to have a closer look at that one later. He next looked at the mortgage entry. The \$3,000 was a year's payments on his 10-year loan for new equipment. The loan was originally for \$30,000. There wasn't much he could do about that.

Bob went back to his accounts payable. He knew that he had grossed \$150,000 for the year, or an average of \$12,500 per month. He also knew that his purchases of materials and supplies normally amounted to about 10 percent of his revenues. To sell \$12,500 in a month, he would have had to buy \$1,250 of materials and supplies. The accounts payable figure of \$5,000 on the balance sheet would therefore be about four months' purchases. All of his suppliers gave him 30-day terms, so he must be behind in paying some of them. Or could it be that his monthly sales in February and March had been

well above the \$12,500 average, requiring heavier purchasing? Or were accounts included that were not materials and supplies?

After checking his monthly sales figures and his list of accounts payable at March 31st, Bob found the answer. Sales were \$12,900 in February and \$11,800 in March. Nothing abnormal about that. But in the accounts payable list all items were materials and supplies, except one, a bill for \$3,800 from Grant Electric for his new outdoor sign and new lighting system in the shop. Unpaid bills for normal purchases of materials and supplies were therefore only \$1,200 of the \$5,000 accounts payable. This was in line with the 30-day terms available.

Debra Drew, the druggist, had said that working capital was the difference between current assets and current liabilities, and that she liked to have twice as many current assets as current liabilities in her drugstore business. She had also said that she had trouble in achieving this.

Bob thought about his own situation. He had just convinced himself that his own current assets and current liabilities were in pretty fair shape. But the current liabilities of \$11,000 were far greater than the current assets of \$1,400. Leduc Cleaners had a working capital deficit rather than a surplus. Yet nothing seemed wrong. Could it be that each business has its own special requirements for working capital?

Yes. A business, such as Leduc Cleaners, with a high proportion of cash sales, and with credit terms for its purchases, will often have current liabilities greater than its current assets.

Let us take a simple example. Suppose Bob Leduc buys 100 coat hangers. He receives them, along with the invoice specifying 30-day terms, on a Monday. By Friday of the same week, they have all been sold as part of his dry cleaning service, and he has been paid in cash. He doesn't have to pay for the hangers for another 26 days so he has cash available to pay other bills. He can order more hangers or other supplies and receive cash for them from his customers, and then pay for the first 100 hangers. He has no need for large accumulations of cash, supplies or other current assets in order to pay his bills on time. He needs only a small amount of working capital.

That is why working capital means more than just the arithmetical difference between current assets and current liabilities to the person

managing a business. **It is really a reflection of the health of each current asset and each current liability under the operating conditions that exist in that business, and none other.** The amount of working capital needed in a business is that which results from each current asset and each current liability being at a manageable level. An example of this is no overdue accounts payable.

As we have said previously, most businesses require a working capital surplus; more current assets than current liabilities. The amounts of these current assets and liabilities and the timing of the operating cycle in each business will determine how much working capital is needed. The small business operator also needs to know what constitutes a manageable or comfortable level for each current asset and liability in his or her business.

## ESTIMATING WORKING CAPITAL NEEDS

Bob Leduc was right. The working capital deficit shown on his March 31st balance sheet was satisfactory for his business at its present sales volume. It provided for payment of current debts as they fell due and it provided for the necessary supplies to do business efficiently.

If Bob had tried to predict in January what working capital he should have by March 31st for a sales volume of about \$12,500 a month, he probably would have estimated as follows:

CASH (nominal balance)	\$ 100	BANK ADVANCES (half of full line of credit)	\$ 2,500
ACCOUNTS RECEIVABLE (1 month's billing to supermarket)	500	ACCOUNTS PAYABLE (30 days' purchases)	1,250
MATERIALS & SUPPLIES (for 15 days, based on purchases of \$1,250 per month)	625	PAYABLE — Grant Elec- tric	3,800
TOTAL CURRENT ASSETS	<u>\$ 1,225</u>	Mortgage — Current	<u>3,000</u>
		TOTAL CURRENT LIABILITIES	<u>\$10,550</u>

This estimate would have shown him that a working capital deficit of \$9,325 would be satisfactory, with each current item at a tolerable level for the business and its creditors. The figures in the estimate are very close to those which actually existed at March 31st as previously shown.

Estimating the working capital requirements of a business requires estimating a workable amount for each current asset and current liability for that business. To make a meaningful estimate requires answers to the following questions:

1. What cash balance is necessary to cover day-to-day needs?
2. What are the receivables normally composed of and what is their likely recovery pattern, in relation to monthly sales? How many days' sales will normally be awaiting payment?
3. What inventories are required to assure uninterrupted operations at the expected volume of business?
4. What bank credit is available?
5. What terms are available from suppliers and what purchases will be needed on these terms at the expected sales volume?
6. Are there any other current liabilities of significant amounts that will become due during the period considered? An example would be mortgage or lien payments and, in Bob's case, the bill for \$3,800 from Grant Electric.

## **WHAT IF SALES INCREASE?**

Many profitable businesses find their progress hampered at times because of a shortage of working capital. Their purchasing power diminishes and their credit reputation may even be affected because they cannot pay their bills on time in accordance with the terms available from their suppliers. This sometimes occurs with businesses experiencing a steady growth in sales, when additional working capital has not been provided to support a higher sales volume. When do sales volumes change so as to affect the required level of working capital?

Changes in sales volume may occur throughout the seasons of every year without a significant change in annual sales. The other situa-

tion is a significant increase in annual sales due to an overall expansion of business. Both situations warrant careful consideration of working capital requirements. These two situations can be illustrated by Drew Drugs.

Let us first consider the working capital needs of Drew Drugs as a seasonal business in which monthly sales vary quite widely during a normal 12-month business year. The critical period will be the peak sales period, the months when accounts receivable and inventories will be highest and support from bank borrowings and suppliers will be heaviest.

Debra Drew's drugstore had sales of about \$240,000 in each of the past three years. That is an average of about \$20,000 per month. In each of those years, her December sales were highest at about \$30,000. At June 30th, 1980, her balance sheet showed:

DREW DRUGS			
Balance Sheet as at June 30th, 1980			
ASSETS		LIABILITIES	
Cash	\$ 500	Bank advances	\$ 5,000
Accounts receivable	4,000	Accounts payable	25,000
Inventory	<u>40,000</u>		
Total current assets	<u>\$44,500</u>	Total current liabilities	<u>\$30,000</u>

Sales in June were \$20,000 and Debra found this situation quite workable. But what working capital would she need next December? She always seemed short at that time each year.

Debra decided to estimate what her current assets and current liabilities would be at December 31st.

At June 30th, her business had \$14,500 of working capital, as shown above. She drew up an estimate of her balance sheet (current portion) for December 31st, 1980, based on a \$30,000 sales level, as follows:

CASH	\$ 500	BANK ADVANCES (limit of her credit)	\$ 7,000
RECEIVABLES (50% more than June 30th)	6,000	ACCOUNTS PAYABLE (50% more than June 30th)	37,500
INVENTORY (50% more than June 30th)	60,000		
TOTAL CURRENT ASSETS	<u>\$66,500</u>	TOTAL CURRENT LIABILITIES	<u>\$44,500</u>

This showed a potential requirement of \$22,000 working capital at December 31st, but she only had \$14,500 at June 30th. The same old story: not enough working capital in December. Where could she obtain another \$7,500 before December?

One source would be the profits of the business from June to December. The business had been generating a cash gain (net profit plus depreciation) of only \$800 per month during the past three years. If this continued from June 30th, 1980, to December 31st, 1980, it would total \$4,800, assuming none of it would have to be spent during that period on such things as fixed assets or mortgage payments. Working capital would then increase by this amount, from \$14,500 at June 30th to \$19,300 by December 31st. But the estimated working capital requirement at December 31st is \$22,000. So another \$2,700 or so would have to be found.

Debra looked at her balance sheet again. Surely, with her good bank record the local bank would be willing to increase her line of credit. She would offer the bank a \$20,000 paid-up personal life insurance policy as security. An increase in bank credit of \$2,700 would probably

solve her working capital problem for next December. Debra remembered that this was all based on an estimate; so to allow for error and flexibility, she applied for an increase in her line of credit from \$7,000 to \$12,000. This would give her access to \$5,000 more bank credit, if needed. Her application was approved.

She summarized her situation as follows:

Actual working capital at June 30th, 1980	\$14,500
Estimated cash gain July 1st — Dec. 31st, 1980	<u>4,800</u>
Estimated working capital Dec. 31st, 1980	<u>19,300</u>
Working capital needed Dec. 31st, 1980	
— using \$7,000 line of credit	22,000
— using \$12,000 line of credit	<u>17,000</u>

The new line of credit would assure a comfortable working capital position during the coming month of December.

Debra then considered the second type of change in sales volume; the moving up to a new plateau in annual sales. She was planning to open a second store in June, 1981, which should increase her total sales by \$100,000 to \$340,000 in the first year. So December 1981 would bring another working capital crisis. She expected the second store would just break even the first year so the cash gain during 1981 would continue to be \$800 per month. She estimated that the combined balance sheet (current portion) for both stores at December 31st, 1981, would look like this:

Cash	\$ 800	Bank advances	\$12,000
Receivables	8,500	Accounts payable	53,000
Inventory	<u>85,000</u>		
	<u>\$94,300</u>		<u>\$65,000</u>

She would need \$29,300 working capital, \$12,300 more than the \$17,000 needed December 31st, 1980, in both cases using the full \$12,000 line of credit. Should she try to find some new money herself to invest in the business, or again rely on bank or other credit?

She remembered that the business would gain cash of about  $12 \times \$800 = \$9,600$  in the twelve months. She decided that she would invest another \$5,000 in the business in 1981 to bolster the working capital. She again summarized her thoughts as follows:

Estimated working capital Dec. 31st, 1980 (using new \$12,000 bank credit)	\$17,000
Estimated cash gain Jan. 1st — Dec. 31st, 1981	9,600
New investment by owner during 1981	<u>5,000</u>
Estimated working capital available Dec. 31st, 1981	31,600
Working capital required on Dec. 31st, 1981 (estimated)	29,300

Debra was satisfied that this plan would satisfy the working capital needs of the business during the peak period of December, 1981. It provided a small cushion of \$2,300 more than the estimated requirement, in case she did not quite meet the estimated figures.

Leduc Cleaners and Drew Drugs are typical small businesses with their own unique requirements for working capital. What is the main reason for the very different working capital needs of each of them? In Bob Leduc's case his inventory requirements are small, about \$800 to be paid for within 30 days. Debra Drew, on the other hand, had to have an inventory of \$40,000, peaking to \$60,000 in December, and she too had to pay her suppliers on 30-day terms. Furthermore, Debra carried \$4,000 to \$6,000 in accounts receivable, as opposed to Bob's \$500. Both businesses have had a successful record, but despite this, serious shortages of working capital could have caused them difficulty, even to the point of failure.

## SIGNS OF A POOR WORKING CAPITAL POSITION

How can you detect a poor working capital position? Check the following:

**The current ratio** (Current assets to current liabilities). There is trouble if it is lower than the industry average.

**Acid test ratio** (The combined total of cash, accounts receivable, marketable securities to current liabilities). Compare your ratio with the industry average.

**Trade payables** Look to see if they are increasing. Look also to see if cash discounts are being taken on purchases.

**Bank balance** Is it sufficient to pay for cheques written on it, or is it plagued by overdrafts?

**Loan payments** Are they falling behind? Are suppliers insisting on COD's only?

**Financial fire fighting** Is the owner spending more time looking for financing to eradicate problems rather than directing the business?

## CAUSES OF A POOR WORKING CAPITAL POSITION

A poor working capital position can be brought on by one or several of the following causes:

- continuing operational losses
- unusual nonrecurring losses such as theft, fire, lawsuits
- overly generous salaries and raises
- over-investment in fixed assets from working capital
- temporary cash shortage which could be the result of a slow payment of a larger-than-normal receivable
- lax collection policies on accounts receivable

- over-investment in slow-moving inventories
- lack of attention to the business's statements and improper interpretation of the statements

## CONCLUSION

The only strict rule of thumb about the amount of working capital a business must maintain is that it be adequate. That means that sufficient cash should be kept on hand to pay for debt obligations as they become due; for payroll disbursements; to benefit from discounts on purchases granted when bills are paid within a specified discount period; to avoid paying penalty fees on unpaid taxes or other such obligations; for the maintenance of a business's good reputation among its suppliers and customers.

## 6. EQUITY CAPITAL FOR SMALL COMPANIES

*"Most successful small companies reach the point where they are ready to invite partners into the business. This sharing of ownership is a major step requiring careful study and consideration."*

— CASE Counsellor

INTRODUCTION .....	70
WHY DO YOU NEED EQUITY CAPITAL? .....	70
EQUITY CAPITAL DEFINED .....	72
ADVANTAGES AND DISADVANTAGES OF USING EQUITY CAPITAL .....	73
WHERE DO YOU OBTAIN EQUITY FINANCING? .....	75
HOW THE OUTSIDE EQUITY INVESTOR LOOKS AT A BUSINESS ....	76
HOW TO APPROACH THE EQUITY INVESTOR .....	77
CONCLUSION .....	78

# INTRODUCTION

As a small business entrepreneur, you will of course want your business to grow in sales, profits, and assets. Growth means expansion. And expansion means additional investment in both fixed and current assets. Ideally, the business's profits should provide the necessary capital for this growth. But too often, instead of using profits, the necessary capital must be sought elsewhere. In most cases, the entrepreneur will approach a term lender. Nevertheless, there is another source: equity financing.

This chapter looks at equity capital for the small company. Beginning with a definition, it examines: why equity capital is needed; what the advantages and disadvantages are; the sources of equity financing. This chapter also includes a section on how to approach an equity investor.

## WHY DO YOU NEED EQUITY CAPITAL?

The following situation will best illustrate why a small business entrepreneur may need equity capital.

Henry McCoy and his son Carl, who is the accountant for Henry's business, were shown into the bank manager's office.

Henry McCoy has been in business for six years and his company, 'McCoy Tooling', is doing very well. Because McCoy Tooling is doing so well is the reason that Henry is seeing the bank manager. They are ready to expand operations. New machining equipment and enlarged premises will see a 30% increase in orders.

This is how a portion of the conversation with the bank manager went:

"This is a lot of money that you need," said the bank manager.

"We're not denying it," replied Henry. "My son has all the figures worked out. The sales will justify the money we need."

Carl confirmed the details of the proposal and showed proof of the expected sales.

"We've always paid back our loan on time," pointed out Carl. "Business is very good and these new orders are guaranteed if we have the new equipment and facilities."

"Don't get me wrong," said the bank manager. "You've got an excellent track record and I could lend you the money."

"So do it," interrupted Henry.

"Listen. For this size of loan and for the security aspect, I'm going to have to spread the loan over ten years. Do you realize what the monthly payments will be? All your 30% increase in sales will be used to pay the loan. And if sales take a dip, then you'd be cutting into the level of profits you're now making."

The manager worked out the repayment schedule with Carl and, based on submitted forecasts, the loan became too onerous.

"Does that mean we can't grow?" suddenly demanded Henry.

"Not at all," answered the manager. "What you need is more equity not more debt financing. With an infusion of additional equity you'll be able to expand operations. Getting this money as equity will mean you won't have to pay it back in installments."

"But," said Carl "for us more equity will mean sharing the ownership of the business."

"That," replied the manager, "is part of the definition of equity and part of its advantages and disadvantages."

Equity capital can be required to:

- develop a new idea, product, process, or service - the feasibility of which is as yet unproved
- start a new business that shows a promising future
- develop or expand an existing business
- re-establish an existing business that is potentially profitable but is experiencing financing difficulties
- purchase an existing profitable business

While equity capital can be required for all of the above, it must be understood that certain situations will be more attractive for an equity investment than others. Generally, equity capital is provided without the complete security of assets, so therefore the degree of risk has to be carefully assessed. Proven profitability lessens the degree of risk and increases the attractiveness of an investment.

## EQUITY CAPITAL DEFINED

Simply stated, **equity capital is that part of the money invested in the business which is not debt.** Stated another way, money is invested into the business which does not have to be repaid in specified installments. Equity capital as an investment is a long-term commitment. However, while it does not have to be paid back in the short term, in the long term it may be paid back if the business is sold, if a partner or partners are bought out, or if shares change hands.

As we have stated previously, equity capital as an investment has a higher risk than does debt financing. Debt financing is usually secured by the business's assets. This is not always so with equity financing. Because of this, the equity investor is looking for a return on the investment by sharing as an owner in the business's profits.

Equity capital, therefore, is termed ownership dollars. This ownership is divided into three categories:

- sole ownership
- partnership
- limited company

Let us look at each category from the point of view of equity capital.

**Sole ownership** The equity capital in your business is derived from your personal savings, securities, real estate, and money borrowed from family and friends. Your equity capital may also be a result of a term loan secured by your personal assets such as your house. As a sole owner, you are responsible for your business's assets and liabilities. As well, the profit or loss of the business is yours alone.

**Partnership** If you don't have enough money from your own sources (described under sole ownership) and you can't or do not wish

to go to a lender, you can obtain equity capital through the addition of one or more partners. A partner or partners provide you with the money you need, but they then become part owners of the business and, as such, share in the profits as well as the losses.

You will have to determine with your partner or partners how much of the business you are going to share. This depends on the amount of money invested as equity capital as well as their share in management decisions. They may be silent partners, where all they do is provide the money and you provide the expertise, or they may be working partners, where they share both money and know-how.

Partners can be either general or limited. General partners are working and active in the business and are liable for any debts or obligations of the business. Limited partners only contribute money and cannot be held liable for the business's debts or obligations.

**Limited Company** The third way of obtaining capital is to become a limited company. A limited company means that you have incorporated your business and can sell shares of the business to a number of specified people. Your business becomes a separate entity from yourself and others who own it. You are all shareholders.

The majority of small businesses which incorporate are private companies. This means that, legally, there is a restriction on the number of shareholders as well as the transfer of shares. The value of the shares and the amount are determined at the time of sale. Control over the business is dictated by who has the greatest amount of shares. Should the business fail, each shareholder is only liable for the shares that he or she has purchased but not yet paid for.

## ADVANTAGES AND DISADVANTAGES OF USING EQUITY CAPITAL

When you have obtained equity capital from sources other than your own, you will no longer be in the category of sole ownership. You will be sharing the ownership of your business. Before taking this step, it is wise to look at the advantages and disadvantages of outside equity capital.

The advantages are:

- it permits faster growth of the business because of readily available money
- it allows expansion of the business's borrowing power in case additional debt financing is needed
- the business may acquire a better reputation and credibility than it could obtain on its own. As well, the business's credit rating with its suppliers can be improved
- outside equity monies normally do not have to be repaid (on a regular basis) and, therefore, they don't drain the business's cash flow
- outside equity capital brings with it not only money, but the investors' advice and expertise in many aspects of management
- because the outside investors have a vested interest in the business, they usually can be approached for continuing support of the business
- by spreading the business's ownership over more partners or shareholders, the business may be more venturesome than if there was only one owner

The disadvantages are:

- loss of flexibility. You will have to share control of the business and will not be the only boss anymore
- sharing ownership means you have a reduced share in the business's profits
- there may be additional expenses such as administrative, accounting, and legal fees. For example, there will be legal costs for drawing up a partnership agreement or for incorporating, and accounting and administrative costs for issuing dividends and keeping records

## WHERE DO YOU OBTAIN EQUITY CAPITAL?

As we saw in one of our previous sections, equity capital was defined by three categories: sole ownership, partnership, and limited company. Sole ownership means your own sources of capital. Partnership and limited company mean an outside equity investor. Where do you find the outside equity investor?

The outside equity sources available to the small business can be divided into private and non-private.

**Private sources** Includes friends and relatives who may be willing to take a share of the ownership in turn for investing their money. Employees may be another source. If incorporated, shares could be sold to employees as a form of employee profit-sharing. Customers and suppliers may also be interested in investing in your business. However, these last two sources could result in undue restrictions on your business's operations and could make other customers and suppliers reluctant to deal with you.

Often your bank manager, accounting firm, or lawyer will be able to direct you to one of their other clients who may be interested in taking an equity position in a promising, small business.

**Non-private sources** Mainly venture capital firms. These are often owned by a consortium of banks, trust companies, or other pools of capital. They specialize in investing in businesses that have a strong growth potential and offer a good realization on investment.

Another non-private source available to a small business is the larger company usually operating in the same field. The motive for a larger company to invest in a smaller one can vary. It can be to control a smaller competitor, to buy an interest in a development process that the larger company may one day value, or to retain contact with an individual whose business may eventually be of use to the larger concern.

## HOW THE OUTSIDE INVESTOR LOOKS AT A BUSINESS

Because the equity investor is making a long-term commitment to a business, he or she will want to be sure that certain factors are present in order for the investment to be realized. Let us examine some of the major factors an equity investor considers when approached by a business for equity capital.

**Potential for growth** The equity investor is looking for significant growth potential in a business that will warrant the infusion of money. Often the value of the original investment in a business is expected to appreciate significantly in the first three years.

**Management** The equity investor will be very interested in evaluating the competency of the business's management, whether it consists of just the owner or a management team. The quality of competency often conditions the degree of the risk of failure and the potential for growth.

**The amount of equity** The equity investor will assess the amount of money to be invested in the business in relation to how long it will take for the majority or all of the investment to be realized.

**Controls** Equity investors, either as partners or major shareholders, will always want to protect their investment. The investor's degree of involvement in the daily operations of the business will depend on the arrangements made with the original owner. Regardless of the day-to-day involvement, most equity investors will wish to provide input concerning large capital expenditures, long-term commitments, and any other major events that could affect the overall financial structure of the business.

**Selling the investment** While equity capital is a long-term commitment, the investor will want to have a good idea at what point he or she could sell the investment. The equity capital position could be sold to: other partners, other private shareholders, an outsider or, if the business is large enough, the public on the stock market. Once the funds are released, the investor is then free to reinvest the money elsewhere.

Equity investors will do all they can to protect their interests. As well, investors will take all the necessary precautions before committing funds. A business, therefore, must look very attractive as an investment.

To help make your proposal for equity capital attractive, the following section will show how to approach an equity investor.

## HOW TO APPROACH THE EQUITY INVESTOR

You can't expect an outside investor to commit money for something that is not planned. Whatever your reasons for seeking equity capital, you must present your case to the investor in a convincing and professional way. It is essential that you document the investment proposal. In short, you must present an equity investor with a well thought-out and realistic business proposal.

Your business proposal should be a very detailed document that answers five crucial questions:

- Is there competent management and is it sufficient for all aspects of the business's operations?
- Does the business have an edge in market, market strategy, product, and service?
- Are the assets of high value and are the business's facilities adequate for the product and service?
- Is there sufficient funding to ensure long-term continuity?
- How will the business grow?

It is to your advantage to present the equity investor with as much information as possible. Your proposal must be professional in appearance and it must be supported by realistic documentation. Be prepared to sell your business yet don't exaggerate as the equity investor will be sharing the ownership of your business and will become aware of any misrepresentation.

The information to appear in your proposal may include:

- a resume of the business
- a resume of the principals and key people
- a description of labour (wage earners and staff)

- marketing details
- research and development details
- operational details
- past financial statements
- future profit and loss statements
- cash flow statements
- personal financial statements
- list of security available
- goals and objectives of the business
- leases, patents, insurance policies, union agreements, mortgage copies, liens, and similar

Remember, above all, that your proposal must show how the new equity capital is going to be used and why. To appeal to an equity investor, your proposal must have strong evidence of growth potential and demonstrate that it is a good investment. When preparing such a proposal, you may wish to consider the services of a professional accountant.

## CONCLUSION

The owner of a small business seeking additional equity capital from outside sources should keep three key points in mind:

- plan carefully, thoroughly, and for the long term
- demonstrate to potential investors that management is competent and that growth prospects are good
- convince prospective investors that the offer of an ownership interest is on terms at least as attractive as other investment opportunities open to them

Outside equity capital means sharing the ownership of your business. So when approaching an outside equity investor for funds, remember you will be sharing the ownership of your business with this person or persons for many years. Choose the equity investor carefully and, ideally, get one who brings to your business more than just money.

## 7. MANAGING YOUR CURRENT ASSETS

*"Good management, or the lack of it, has a major effect on the condition of your current assets."*

— CASE Counsellor

INTRODUCTION .....	80
LISTING YOUR CURRENT ASSETS .....	80
CASH .....	81
ACCOUNTS RECEIVABLE .....	82
INVENTORIES .....	84
EXPANDING YOUR BUSINESS .....	87
CONCLUSION .....	89

# INTRODUCTION

Current assets are what a business owns in the way of cash or things that can be converted to cash within one year. Therefore, aside from actual cash, current assets include: quickly marketable securities such as bonds, inventories that can be sold for cash or on credit, and accounts receivable which represent cash paid in installments.

Managing your current assets means more than managing the amount of each of these components: cash, inventory, and accounts receivable. It means managing the flow of cash as it is converted to inventory, then to accounts receivable, then back to cash.

The cash cycle in a business i.e. from cash to inventory to accounts receivable to cash, is like the cycle in nature when water in a lake evaporates to form clouds, which in turn form droplets which fall as rain into the lake. Just as a drought may occur if a lake evaporates but condensation in the form of raindrops does not refill it, so too can a business's cash resources dry up, preventing the acquisition of new inventory, the sales of which would replenish the cash resources.

The owner of a business must ensure that this flow is not interrupted by having cash tied up almost exclusively in slow-moving inventory or in aging accounts receivable.

This chapter will focus on the current assets of 'Small Enterprises Ltd.' and will illustrate ways to effectively manage cash resources, accounts receivable, and inventories. The methods shown can be used for a comparable business.

## LISTING YOUR CURRENT ASSETS

As the owner of a small business, how much of your investment should be in current, as opposed to fixed, assets?

To ascertain this proportion, you must find out how much cash, accounts receivable, and inventories your business needs. These needs occur when you start-up, when you are operating during busy and quiet seasons, and when you wish to expand.

Let us take a look at the balance sheet of Small Enterprises Ltd.

**Small Enterprises Ltd.**  
**Balance Sheet — December 31st, 1980**

**ASSETS**

Cash on hand	\$ 200
Cash in bank	2,000
Canada Savings Bonds	1,000
Accounts receivable	5,500
Inventories	<u>7,000</u>

Total Current Assets      \$15,700

**LIABILITIES**

Bank Loan	\$4,000
Accounts payable	2,000

Total Current Liabilities      \$6,000

Note that its assets are listed in order of ease of convertibility to cash, starting with cash itself.

Let us suppose that this business is selling about \$5,000 in goods or services per month during the winter. Is it managing its current assets effectively?

## CASH

Most small businesses need a petty cash fund to take care of daily expenses. The question is: how much cash? And the answer is: as much as the business needs to meet its cash requirements on a day-to-day basis.

To find out how much the business needs, owners should prepare cash flow forecasts (described in detail in the chapter entitled "Managing your Cash") which show on a month-to-month basis what cash they estimate they will receive, what cash they will have to pay out, and where they will have cash surpluses or shortages.

From such a forecast, they will know how much cash they should keep on hand on a day-to-day basis.

Is the \$200 that Small Enterprises Ltd. keeps on hand sufficient? For day-to-day operations, yes. The amount should be kept to a minimum — just enough to take care of the business's needs — because cash on hand does not generate a return on investment.

The \$2,000 cash in bank, on the other hand, looks excessive for normal operations of the business. The company is receiving bank credit, and unless this relatively large deposit was needed for a special purpose at the balance sheet date, it seems unjustified. Likewise, the investment in Canada Savings Bonds might be better employed in financing the operation of the business.

With reference to the need to manage the flow of cash through the business, Small Enterprises Ltd. is not putting its cash into the flow. Too much of its cash resources is static. The business's growth may be stunted.

## **ACCOUNTS RECEIVABLE**

The chapter, "Giving Credit to your Customers", outlines briefly some of the principles of a credit system for a small business. The amount of your accounts receivable, the amount owed to your business by customers for goods or services you sold them on credit, will depend to a large extent on the rules you have set up for granting credit to your customers and the way you apply them. If your credit terms are vague and your invoicing system sluggish, your accounts receivable will tie up too much of your investment. This costs your business money.

There are two simple ways of keeping an eye on your accounts receivable.

### **1. Aging your receivables**

One is to age them, that is to classify them according to their age since the date of sale. In the case of Small Enterprises Ltd., an aging of the \$5,500 accounts receivable at December 31st, 1980, shows the following:

Receivables outstanding less than 30 days	\$4,400	80%
Receivables outstanding 30 to 60 days	770	14%
Receivables outstanding over 60 days	<u>330</u>	<u>6%</u>
	<u>\$5,500</u>	<u>100%</u>

If the selling terms of this business are net 30 days, 20 percent of its receivables are overdue. If these overdue accounts didn't exist, the \$1,100 tied up in them could be put to use in producing more goods or services for sale.

The aging analysis, made up from a listing of all your individual accounts receivable, can be done quite quickly on a regular basis, for example, at the end of each week or month. If you know your customers, you will also know from the aging analysis what quality the overdue accounts have, that is, what likelihood there is of collecting each, or whether a bad debt loss might be expected from some.

You can also see from examining the accounts receivable whether any overdue amounts comprise mainly one or two large accounts. Just ask your bookkeeper to list separately the accounts overdue in amounts of more than, say, \$100 or an appropriate amount that is large for your business. In the preceding example, it might be that the \$330 outstanding over 60 days is all due from one customer. If steps to collect from this one customer were applied successfully, the accounts receivable picture would improve sharply.

You can also determine, from the aging schedules for several consecutive periods, whether your collections are improving or whether old accounts are piling up. This might suggest a need for changing your credit terms and collection practices.

## 2. Calculating your average collection period

If your credit and collection system is under control, the level of your accounts receivable will likely vary directly with sales volume. Another simple test is to calculate the average collection period. The formula for calculating your annual average collection period is:

$$\text{Average Collection Period} = \frac{\text{Accounts Receivable}}{\text{Annual Sales}} \times 365 \text{ days}$$

If Small Enterprises Ltd. had sales of \$75,000 in 1980, the accounts receivable of \$5,500 at the end of that year represent about 27 days' sales ( $\$5,500 \div \$75,000 \times 365 \text{ days}$ ). The average collection period is, therefore, 27 days. It would be even more accurate to calculate the average collection period by using the average of the accounts receivable at the beginning and at the end of the year. Also, the calculation could be based on business days in the year, rather than calendar days. This involves a bit more work, but the main point is to do it the same way each time.

The average collection period can also be calculated on a monthly basis, each month-end. If December 1980 was a slow month for Small Enterprises Ltd., with sales of only \$5,000, the accounts receivable of \$5,500 at the month-end were 34 days' sales ( $\$5,500 \times \$5,000 \times 31$ ). This is higher than the year's average collection period of 27 days' sales, and might be an indication of a slow-down in collections. If so, steps should be taken to urge more prompt payment by customers. On the other hand, it could be that the business normally gives more credit in December than at other times of the year. The circumstances will indicate what collection steps, if any, are required and care should be taken to achieve the best results with a minimum of offence to customers.

## INVENTORIES

To control your investment in inventories you need to know regularly what quantities of materials, supplies, and finished goods your business requires in stock and what value to give to them.

The inventory of a manufacturing business will normally include raw materials, goods in process, finished goods, parts, and supplies, such as the packaging materials for the finished products. In non-manufacturing businesses the inventory may consist of supplies or finished goods, or both.

Consider first the size of inventory required. It is common practice in many businesses to take a physical count of the entire inventory at the end of each business month. This tells you how much inventory you

actually have. But how much should you have for good control of your investment?

Generally speaking, the smaller the inventory you can carry and still not run into shortages and slow deliveries to customers, the better. So you should know how fast your finished goods inventory moves out of your business to your customers, that is, how fast it turns over. Unfortunately, most businesses cannot stock their products just to meet firm orders. They have to have additional goods on hand at all times. Your customers expect you to supply exactly what they want when they need it, or they will buy elsewhere. A complete inventory is needed, including fast-moving and some slow-moving items, but your business should not be overburdened with the latter. If you know where you can get some of these items quickly, perhaps in one day's delivery, you may not need to stock them. You should also know what minimum and maximum inventories you need for your slow and busy sales seasons.

Small Enterprises Ltd. is a manufacturer, and \$2,800 of its year-end inventory of \$7,000 was raw materials. This amounted to about 17 days' sales, with December sales of \$5,000. January sales were expected to be the same. The company had found from experience that 17 days' sales was an adequate inventory of raw materials to keep its production running on schedule. Alternatively, the company could compare its inventory with its purchases rather than sales, and express the inventory as so many days' purchases. It forecast its sales and corresponding material purchases for each month of the coming year using the formula:

$$\text{Avg. Raw Material Inventory} = \frac{17 \text{ (days' sales)}}{31 \text{ (days in mo.)}} \times \text{Monthly Sales}$$

The company then bought its raw materials in advance accordingly. For a month in which \$8,000 sales were forecast, it would increase its raw materials level to about \$4,500, 17 days' sales. This requires a close watch on purchasing and familiarity with delivery times, price changes, and discounts available.

Small Enterprises Ltd. had a goods-in-process inventory valued at \$200 at December 31st. This was the value of the partly-finished products in the plant at the end of that day. In some circumstances this can be reduced by speeding up the plant either mechanically or by using more labour, or by improving the scheduling of production.

This company had finished goods worth \$4,000 at December 31st. There were ten different products and each item was recorded on a card showing the quantity on hand, its value, and the re-order point. When the quantity was reduced to this re-order amount, the company would produce or re-order that product. Inventory control systems are described in many readily-available publications.

In many businesses, such as this one, a small percentage of the inventory items account for a large percentage of sales. Small Enterprises Ltd. found its breakdown to be:

Products	% of Inventory	% of Sales
1 and 2	20	75
3, 4 and 5	30	15
6 to 10 inclusive	50	10

Obviously, products 1 and 2, the fast movers, should receive close attention in the inventory as they account for 75 percent of the company's sales. The finished goods inventory can be reduced if more firm orders are obtained, and production is scheduled for their immediate delivery.

Another way of determining whether your inventory is too large or too small for the size of your business is to compare it by each category with your average monthly sales for the preceding several months. Six months is a suggested period of time.

Small Enterprises Ltd. had the following sales for the last half of 1980:

Month	Sales
July	\$ 8,000
August	8,000
September	7,000
October	6,000
November	5,000
December	<u>5,000</u>
6 Months Total Sales	\$39,000
Average Monthly Sales	\$ 6,500

The total inventory of \$7,000 at December 31st was, therefore, about 32 days' average sales. The company had found that a total inventory of about 30 days' average sales was sufficient for normal operations and had gradually reduced it for the fall and winter, its slack season. It would continue to reduce it to about \$6,500.

So much for the quantities of inventory required by a business. How do you price the quantities?

A simple method is to price each item at cost or market value, whichever is lower. This avoids overstating the value of your inventory in the event of a decline in the selling price of certain items.

In pricing the finished goods inventory in some businesses, certain items may also lose all or part of their value because of spoilage, a sharp change in fashions, or other factors.

## EXPANDING YOUR BUSINESS

If the sales of your business are increasing sharply, or if you plan an expansion to increase your sales, you should also plan what current assets your business will have at the new sales volume. Generally speaking, your accounts receivable and inventories will increase, but normally you would not need more cash on hand or on deposit.

Small Enterprises Ltd. had sales of \$75,000 in 1980, 20 percent more than its volume of \$62,500 the year before. It had studied its orders and markets carefully and forecast sales of \$90,000 in 1981, another 20 percent increase. This would be more than the plant could produce unless it added another machine early in 1981. The company decided to buy the machine and it would be in production in March. What investment would it need in current assets at this higher level of sales?

Cash on hand of \$200 could be maintained but the \$2,000 cash in bank and \$1,000 Canada Savings Bond could be spent on new materials and supplies. Accounts receivable would be expected to increase to \$6,650, still averaging 27 days' sales at the new sales volume, i.e.:  $27 \div 365 \times \$90,000$ .

Based on the past, the average raw material inventory should be increased to about \$4,200, or 17 days' sales ( $17 \div 365 \times \$90,000$ ). Its goods-in-process would likely increase due to the additional machine to perhaps \$240. Similarly, 20 percent more finished goods, i.e., \$4,800 on the average, might be needed to fill the additional orders, although this would depend on the new higher production rate and the proportions of items being sold. This would mean a total inventory of \$9,240, rather than the former level of \$7,000.

In summary, the old and new levels of inventory would be as follows:

1980 Sales \$75,000		1981 Sales \$90,000	
Raw materials	\$ 2,800		\$ 4,200
Goods in process	200		240
Finished goods	<u>4,000</u>		<u>4,800</u>
Total Inventory	\$ 7,000		\$ 9,240

The current part of the company's balance sheet might look like this during the next peak sales period, say June 30th, 1981.

Small Enterprises Ltd. Balance Sheet — June 30, 1981			
ASSETS		LIABILITIES	
Cash on hand	\$ 200	Bank Loan	\$3,000
Accounts receivable	6,650	Accounts payable	<u>2,400</u>
Inventories	<u>9,240</u>		
Total Current Assets	\$16,090	Total Current Liabilities	\$5,400

## CONCLUSION

Aging of receivables, calculating the collection period, and analyzing the inventory by size and products are a few simple checks that can guide you in managing your current assets. If done regularly, they can help you to keep your investment in current assets at a level your business needs so as to function day-by-day, and to grow year-by-year.



## 8. MANAGING YOUR FIXED ASSETS

*"Fixed assets don't produce sales, but they should produce profits."*

— CASE Counsellor

INTRODUCTION .....	92
THE VALUE AND DEPRECIATION OF YOUR FIXED ASSETS .....	92
LAND .....	94
BUILDINGS .....	95
FURNITURE AND FIXTURES .....	97
MACHINERY AND EQUIPMENT .....	98
VEHICLES .....	99
INTANGIBLE ASSETS .....	102
CONCLUSION .....	103

# INTRODUCTION

Fixed assets are the assets a business requires to enable it to make sales and, if necessary, to produce the goods and services it has for sale.

Fixed assets differ from current assets in two respects:

- they are not for sale (unless disposed of under special circumstances such as relocation)
- they remain in the business for longer than a year

Fixed assets include: land, buildings, machinery, equipment, vehicles, furniture, fixtures, and patents. They do not get used up or consumed in the same way as the materials used to manufacture products or services for sale. However, a part of the useful life of fixed assets goes into the production of each of the business's products and services. Fixed assets can be expected to lose value as they deteriorate or break down during their lifetime. Only land does not depreciate, although in special cases, such as land containing mineral reserves, the value may depreciate with the depletion of the natural resource.

This chapter will focus on the major ways of managing your fixed assets. The purpose of managing fixed assets is to keep fixed expenses such as interest and depreciation under control so that you can keep your selling prices competitive.

## THE VALUE AND DEPRECIATION OF YOUR FIXED ASSETS

Like current assets, fixed assets are listed on the left side of your balance sheet. They appear below the current assets, and are listed in the order of their expected useful life. Assets with the longest expected life are listed first as in the following example:

Land	\$ 2,000
Buildings	20,000
Furniture and fixtures	2,000
Machinery and equipment	10,000
Vehicles	3,500

The value shown initially on the balance sheet for each type of fixed asset is normally the cost incurred by the business to acquire the assets. Obviously, equipment, buildings, and vehicles deteriorate with use. Their value decreases so that they are no longer worth their original price. Each year, therefore, their book value is reduced to reflect that deterioration. The amount of that reduction is charged as an expense to the business for the year, and is shown on the profit and loss statement for the year as a depreciation expense or depletion allowance.

There are various optional methods to calculate depreciation of fixed assets, among them: the straight-line method; the payback method; the rate of return method; and, the net present value method. When choosing one of them, take into consideration your business's size and profit picture. Seek the advice of an accountant. Have this person explain the particular benefits of each method and recommend the one best suited to your business.

Not optional, but mandatory, is the diminishing balance method which you must use when calculating the income tax payable by your business. According to this method, you reduce the book value of each fixed asset by a fixed percentage each year. The federal Income Tax Act stipulates what maximum percentage of book value you can charge as a tax-exempt business expense for each type of fixed asset. By this method, the amount of depreciation charged keeps reducing year by year as the book value reduces each year.

One of the simplest methods and the one most commonly used by businesses for their own records is the straight-line method. According to this method, a fixed asset is depreciated by the same amount for each year of its useful life. Thus, if a new machine costing \$1,000 is expected to be used for ten years, and to have a salvage value of zero after that time, \$100 of depreciation would be charged in each of the ten years that the machine is used.

On the balance sheet, these yearly charges for depreciation are accumulated as follows:

		Book Value after Accumulated Depreciation
Land		\$ 2,000
Buildings	\$20,000	
Less Accumulated Depreciation	2,000	18,000
Furniture and fixtures	2,000	
Less Accumulated Depreciation	200	1,800
Machinery and equipment	10,000	
Less Accumulated Depreciation	2,000	8,000
Vehicles	3,500	
Less Accumulated Depreciation	1,050	2,450

Let us now look at each of the major assets that can constitute the term fixed assets.

## LAND

The initial price of the land is only one consideration when you are looking for a site for your business. Location is another. Where is your market? Where do you get your materials and labour? Is the shape of the site suitable for your building and operation? Is there good access to it? Is it completely serviced? What are the taxes? Are there any zoning or other restrictions about building? Is parking space adequate? Such considerations may be more important to the long-term success of your business than the initial price of land.

No matter what site you select, don't forget about future expansion. If the sales of your business increase 10 percent per year, they will double about every seven and a half years. If they increase 15 percent per year, they will double every five years. This kind of sales growth requires more space and the regular addition of other facilities. Is your land site large enough for such growth, or alternatively, would it be feasible to move the business to a larger site in five or ten years? A site that is too

large for your present requirements need not remain idle. Lease the excess space to another business until you require it for your own expansion. Rental income from that portion of your land can then be available for working capital.

## **BUILDINGS**

Before selecting a building for your business, you should give careful thought to the arrangement of the machinery, equipment, and work areas inside the building. Prepare a layout of the floor area on paper, using moveable blocks of heavy paper representing to scale every major piece of equipment, machinery, etc.

Picture in your mind how the people and materials will move in your building. Then move the models around on paper to give you the most efficient arrangement. This should result in a smooth flow of traffic without too much criss-crossing. It should also provide easy passage of goods into the receiving area and out of the shipping area. If you don't feel qualified to make your own plant layout, hire a consulting engineer to do it for you. But above all, do prepare a layout! Moving a machine on paper ahead of time is much cheaper than moving the actual machine from a bad location later. Why not visit a few buildings used for the same type of business? Study their layouts, and you may benefit from their experience, or from their oversights.

Don't forget about future expansion, either horizontal, or vertical, or both. If you expect to expand horizontally, your plans might call for a temporary wall on one side, adjoining the vacant land area on which you will expand. If you are thinking of vertical expansion, make sure the building columns are designed to support a second storey.

Common-purpose buildings are the most readily saleable, so avoid, if possible, any special features that would detract from the building's attraction to other businesses. You might want to sell it or rent it sometime. A standard pre-fabricated building, adaptable to most purposes, might have more appeal to a prospective tenant than a custom-designed building.

Heat, water, electric power, and waste disposal are services your building will require. You will need to know what type and quantity of each of these services will be needed before deciding on the equipment

and distribution for your building. You may have to install pollution controls for your type of business. You may also need air-conditioning, refrigeration, and special materials-handling equipment such as power conveyors. Suppliers of this equipment can help you select the best size for your purpose.

Choosing a suitable, fully-serviced building is one of the most important business decisions you will have to make. When you have taken stock of all of your requirements, get professional help for the final design, for the obtaining of a construction contract by tender, and for the supervision of construction.

As previously mentioned, the federal Income Tax Act allows you to charge each year, as a business expense which will not be taxed, an amount for the depreciation of your building, if it is owned by your business. Assume current maximum depreciation rates are 10 percent per year on frame buildings and 5 percent per year on brick or masonry buildings. Apply these percentages to the book value of the building, that is, the cost less the depreciation you have charged to date on the building, using the diminishing balance method.

Suppose you are considering the purchase of a warehouse building. Two new buildings of the same size are available, one of steel frame and brick construction, and the other of wood frame and siding. Which should you buy? There are several methods of comparing, in financial terms, the relative merits of alternative choices of fixed assets, such as buildings. The total annual cost method is one you could use. A comparison could take the following form:

<b>DATA</b>	<b>Building A Steel &amp; Brick</b>	<b>Building B Wood</b>
Initial cost	\$120,000	\$56,000
Interest rate	15%	15%
Depreciation	5%	10%
Taxes	8%	8%
Fire insurance, annual, per \$100		
Building	2.00	5.00
Contents (Value \$30,000)	2.50	6.00
Business loss insurance	1,200	1,400
Operating cost disadvantage	—	1,000
<b>ANNUAL COST</b>		
Interest	18,000	8,400
Depreciation	6,000	5,600
Taxes	9,600	4,480
Fire insurance, building	2,400	2,800
contents	750	1,800
Business loss insurance	1,200	1,400
Operating cost disadvantage	—	1,000
<b>TOTAL ANNUAL COST</b>	<u>\$ 37,950</u>	<u>\$25,480</u>

In this case, the wooden building should be purchased because of its lower annual cost.

## FURNITURE AND FIXTURES

You need comfortable, quiet offices where you and your employees will function effectively, and where you can conduct your business in an organized manner.

In some businesses, it makes good business sense to decorate your office interiors to create a fashionable image, and to display the goods, workmanship, and services of your business in an appealing way. In such cases, some extra investment in furniture and fixtures is warranted. But

don't overlook the fact that good service is usually a far more compelling force in attracting and keeping customers than luxurious, expensive office furniture.

## MACHINERY AND EQUIPMENT

James Watt, who patented one of the first practical steam engines in 1769, said: "Of all things, but proverbially so in mechanics, the supreme excellence is simplicity." This is particularly true of machinery and equipment for a small business, where high initial costs and subsequent maintenance costs for overly sophisticated models may be prohibitive. In fact, such machines may cause excessive stoppages of production, where a simpler model would keep running.

When selecting equipment you need to be specific about what it should do for you. How many units of your product should the machine handle in a given time to meet your sales requirements? How many operators can you afford to run it? How much space is available for it? What quality must it be able to produce? There's probably a machine available to meet your basic requirements. So make the machine match your requirements. If you were to purchase a sophisticated machine on impulse, and then try to make your plant match the requirements of the machine, you would be wasting some of the money you have invested in your business.

If you are manufacturing products, it is your machinery, equipment, and employees that will make profits for your business — not land, buildings, and furniture. Search for simple, good quality machinery and equipment at the lowest cost rather than top-of-the-line items at high cost.

Suppose you are considering the purchase of a machine for your business such as a power lathe for your machine shop. A common method for analyzing such a purchase is the payback method. Will the savings from the machine pay for the machine before it wears out? A lathe might be available for \$4,000 that would last you 8 years and would save you \$1,000 in labour each year. The payback period would be:

$$\frac{\$4,000}{\$1,000} = 4 \text{ years.}$$

This sounds attractive because the lathe would pay for itself in much less than its expected useful life. You should probably buy it. But is there a better buy available?

Another supplier will sell you a more versatile lathe for \$6,000 that should last 10 years and should save you \$1,500 in labour each year. The payback period would be:

$$\frac{\$6,000}{\$1,500} = 4 \text{ years.}$$

the same as the first example, so this one sounds attractive, too. Now what do you do to choose between them? Look at the expected useful life of each machine. The \$4,000 lathe will pay for itself in 4 years, or 50 percent of its useful life of 8 years. But the \$6,000 lathe will pay for itself in 4 years, only 40 percent of its useful life of 10 years. Your best investment is the \$6,000 machine, which pays for itself relatively sooner in its useful life.

Consider leasing as an alternative to purchasing machinery or equipment. The following factors favour it:

**Potential obsolescence** If the machinery or equipment required for your business were to become obsolete in a short time, leasing is preferable to purchasing. This factor is especially important when the acquisition of computer hardware is contemplated.

**Imminent government regulations** If government regulations, especially in the areas of permissible energy consumption levels or pollution control levels, were to require expensive modifications to your equipment, lease the equipment until the regulations become effective.

**Need for working capital** Leasing frees cash for this purpose.

## VEHICLES

Does your business need to own vehicles at all? If the answer is yes, consider leasing vehicles, particularly if you require one or two new ones all the time for sales purposes. On the other hand, if you need a light delivery truck, you would probably use it for several years and then sell it for scrap or trade it in. Purchasing, rather than leasing, such a vehi-

cle would probably be wise because the average annual cost over its life-time would be quite low.

The factors favouring the leasing of machinery and equipment also apply to vehicles. There are two kinds of leases to choose when leasing a truck: the capital lease and the operating lease. The capital lease is generally long-term. The accumulated payments nearly equal the truck's purchase price. The advantage of such a lease is that a business can use the capital lease as a substitute for a loan to purchase. If a fleet is being leased, the interest charges may be well below the prime rate. A disadvantage is that the lessee must be willing to maintain, operate, and dispose of the trucks involved.

With an operating lease, the lessee pays only for the use of the truck when he or she needs it. The lessor provides the maintenance and insurance and disposes of the truck when the lease expires. However, the truck is not counted on the lessee's books as an asset, although this may be negotiable. Operating leases are generally more expensive than capital leases because of the services provided.

Owning vehicles involves a business in two kinds of expenses: fixed expenses and variable expenses. The fixed expenses for a vehicle are those you will have to pay regardless of how much you use the vehicle, even if it remains in your parking lot most of the time. These fixed expenses include insurance, license fees, seasonal servicing, and, of course, depreciation. Generally speaking, the more expensive vehicles have the higher fixed expenses. Variable expenses are those which will vary according to the number of miles a vehicle is driven. Variable expenses for a vehicle mean the cost of fuel, oil, tires, spark plugs, and other replacement parts. As a rule of thumb, the further a vehicle is driven, the lower the average variable expenses per mile. And a more expensive vehicle does not necessarily have much higher variable expenses than a cheaper one.

The following situation will illustrate what must be considered when purchasing a vehicle:

The decision whether to buy an \$8,000 car or a \$12,000 car plagued Karen Bancroft for weeks. Her interior decorating business, though still in its infancy, was growing steadily. Given the size of the business, the \$8,000 car seemed appropriate. But because so much of her time was spent escorting clients to warehouse showrooms to look at wallpaper designs and carpet samples, she wanted a car that would be comfortable for herself and her clients. The car was also to serve as a kind of mobile office in which she would talk shop with her clients.

To help her decide which car to choose, she compared the major fixed and variable expenses expected for each car. She assumed that whichever car was bought would be replaced in three years with a certain trade-in value. Before totalling her fixed expenses, she made the following assumptions:

	<b>Car A Price \$8,000</b>	<b>Car B Price \$12,000</b>
Replacement period	3 years	3 years
Trade-in value in 3 years (estimate)	\$4,000	\$6,000
Cash outlay at replacement	\$4,000	\$6,000

When listing her fixed expenses such as insurance, license, seasonal tune-ups, 20 car washes per year at \$5 per wash, she included \$1,333 per year for Car A's replacement (1/3 of cash outlay at replacement), and \$2,000 per year for Car B. She discovered that total fixed expenses for Car A would be about \$3,000, and for Car B, almost \$4,000.

Among the variable expenses, Karen included the cost of: fuel (cents per kilometre); tire replacement every 35,000 kilometres; replacement of oil, oil filters, spark plugs, shock absorbers, winter tires, etc. Total variable expenses for Car A came to \$0.098 per kilometre, and for Car B, \$0.111 per kilometre.

Karen's figures showed her that the operating cost for both cars at low mileage is high and well above leasing rates for similar cars. But at

30,000 or 40,000 kilometres per year, the higher-priced model became relatively more attractive i.e. the cost per kilometre was not much higher than the cheaper model. Also, at the same higher mileages, leasing rates were less attractive in comparison. Karen now had all the evidence she needed to purchase Car B.

## **INTANGIBLE ASSETS**

The fixed assets, described to this point, are tangible fixed assets. In other words, they have physical substance. Fixed assets can also be intangible, for example, things used in the operation of the business which do not have physical properties, such as patents or copyrights. The value of such intangible assets is in the rights which their possession gives to your business. Even intangible assets have a limited useful life and their value, or cost, in most cases, may be charged off gradually as a business expense during their estimated useful life. The systematic write-off for intangible assets is usually called amortization. It is a similar idea to depreciation for tangible fixed assets (except natural resource fixed assets, such as mineral or timber rights, for which the term depletion is used).

Some intangible fixed assets may have an indefinite useful life. Examples are: goodwill, rights, and franchises without a termination date. These may also be amortized; otherwise, they might have the effect of overstating your balance sheet at a later date. Such assets as goodwill have been known to become valueless during the life of a business.

## CONCLUSION

The fixed assets of your business, though not sold like products or services, have a direct bearing on your selling prices. A part of their original value goes into the production of your goods or services during their useful life, except in the case of land.

This wearing out of fixed assets, or depreciation, is a business expense. It is an allowable deduction from the income of your business before taxation.

Before choosing fixed assets, you should consider not only their cost, but the future expansion needs of your business. Alternatives, such as leasing certain fixed assets, or purchasing used items should also be considered. Whether leased or purchased, your fixed assets should contribute to your business's profits.

Good management of your fixed assets will keep your fixed expenses, such as interest and depreciation, under control and your selling prices competitive.



## 9. MANAGING YOUR CASH

*"It is not uncommon for businesses to make profits and yet be in trouble because they don't have ready cash to pay current bills."*

— CASE Counsellor

INTRODUCTION .....	106
WHY MANAGE YOUR CASH? .....	106
WHAT IS CASH MANAGEMENT? .....	108
PREPARING A CASH FLOW FORECAST .....	109
CONCLUSION .....	114

# INTRODUCTION

Almost every decision the small business entrepreneur must make has financial implications. Being a good financial manager is, therefore, crucial to the business's success.

One important aspect of financial management is handling the business's cash. You need readily available money to run your business on a day-to-day basis. Inevitably there are suppliers presenting you with bills, some of which may be higher than anticipated. A sudden repair to your premises may be more than expected. You must account for expenses such as these.

Lack of sufficient cash may result in serious problems. Too much cash, however, is a waste of the business's resources. A balance between the two extremes can be achieved with good cash management. The most important tool of cash management is the cash flow forecast, which will help you determine how much cash you need and when.

This chapter will acquaint you with the basic principles of cash management. It will discuss the need for, and the purpose of cash management and will illustrate the preparation of a cash flow forecast.

## WHY MANAGE YOUR CASH?

Unfortunately, many small businesses learn too late the answer to the question: Why manage your cash? The following situation is a good illustration of why cash management is so important to the success of a small business:

Cathy and Madeline are partners in a new toy shop in the town's mall. They have been in business now for over a year and are showing a good profit. Yet paying bills always seems to be a problem for them.

"Cathy, the man is here with the teddy bear shipment."

"Tell him to put it in the back."

"Where to put it isn't the problem," explained Madeline. "It's been sent COD because we missed our payment last month."

"Damn it. We need those bears. And I can't write a cheque. How much is the bill?"

"It's almost \$450," answered Madeline. "Is there enough in the cash register?"

"I'm not sure," said Cathy opening the till. "I hate taking money out like this when I haven't balanced the till and tape for the last couple of days."

"Let me see how much is in the petty cash box," offered Madeline. "I took some money out yesterday. I forgot to put in a voucher, but I think there's almost a hundred dollars."

By combining the money in the cash register with the hundred dollars from petty cash, Cathy and Madeline were able to pay the COD shipment.

"I don't understand," said Madeline later that afternoon as they were placing the teddies on the shelves. "Sometimes we have lots of cash and other times not a cent. And yet our profit and loss statement for the first year looks good."

"I know," said Cathy. "And now that we've put out cash for the bears, what about the rent due next week?"

"Wait," said Madeline. "We've got the charge card slips to bring to the bank, so we should be O.K."

"I forgot about that. What a relief! But we can't keep on like this. There must be a way of knowing what cash we will need and when and from where it will come."

The above is a classic situation of a small business showing a profit yet having cash availability problems. Cathy asked if there was a way of knowing ahead of time what cash would be needed and when and from where it would come. Yes, there is a way. It is called cash management.

## WHAT IS CASH MANAGEMENT?

When we talk about cash, we are referring to the money a business has in its till, in petty cash, or in the bank. There are basically two reasons why a business must have sufficient cash on hand:

- to be able to pay regular bills and other expenses when they come due
- to account for uncertainties and faulty estimates of planned expenses

Insufficient cash can result in serious problems. The extreme result is, of course, the business's insolvency. A less serious result is having to delay paying your bills. The inability to pay quickly will first mean the loss of any supplier's discounts on invoices that are paid promptly (e.g. 2% discount if paid within 10 days of invoice date). Secondly, consistent delays in repayment will eventually affect the credit rating you have with your suppliers.

Holding too much cash, however, is also not recommended.

Too much money means that your cash resources are not being used to their best potential. Money that sits idle ultimately costs you money. How? It costs you money if it does not earn interest; if by sitting idle for a long period of time it is affected by inflation; and, if it is not used to pay liabilities that are incurring interest charges.

Of course, it is better to have too much money than too little. It is even better to have the right amount. Cash management determines, as accurately as possible, what the cash balance should be at all times.

Cash management can be divided into two activities: regular controls and the cash flow forecast.

Regular controls of your cash are:

- a) **At the till** — till and tape balances should be balanced. Cheques,

which you may want to personally approve before they are honoured, should be deposited with your bank as soon as possible.

- b) **At the petty cash box** — you will want to ensure that the amount which you have set as a petty cash reserve is always there in either cash or vouchers.
- c) **At the bank** — you will want to reconcile your records and your bank's records of deposits and withdrawals, and provide for cheques which you have issued but which have not yet reached your bank.

The cash flow forecast, which is also referred to as a cash flow budget, can be described as:

- Showing, on a month to month basis, what cash you estimate to receive, what cash you will have to pay out and where you may have cash surpluses or shortages.

Let us next look at how a cash flow forecast is prepared.

## PREPARING A CASH FLOW FORECAST

Basically the cash flow forecast or cash flow budget simply illustrates the flow of cash through a business for a future period of time, usually six to twelve months. In other words, it shows when cash will be received and the amount, and when cash will be paid and the amount, for this prescribed period of time. A cash flow forecast is usually divided by months.

Here is an example of a cash flow forecast. Not all of the lines are applicable to every small business, but the majority of them can be completed.

# **Cash Flow Forecast** for the period \_\_\_\_\_

Jan.                  Feb.                  March

## Add Cash Receipts:

Cash from Sales  
Cash from Receivables  
Loan Proceeds  
Cash from Other Sources

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

## Total Receipts

## Less Disbursements:

Improvements  
Fixtures  
Equipment  
Inventory  
Management Salaries & Taxes  
Employee Wages & Taxes  
Rent  
Mortgage Payments  
Heat, Light & Power  
Office Expenses  
Maintenance & Repairs  
Advertising  
Insurance  
Legal & Audit Fees  
Miscellaneous Expenses  
Loan Repayment  
Income Taxes

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

## Total Disbursements

## Cash Surplus (Shortage)

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

## Cash on Hand:

Beginning of Month  
End of Month

Let us review the sample cash flow forecast line by line.

<b>Cash from Sales</b>	Use this line for sales that will generate immediate cash during the month. In other words, the customer pays cash, by cheque, or by charge card for merchandise or services purchased from you.
<b>Cash from Receivables</b>	This line is for sales that have been taken on credit. The actual sales may be one or two months previously, but this is the month when you expect to receive the cash. For example, if your terms are 30 days and a sale took place January 15th, you would forecast payment to be received in mid February. Note that your cash from receivables will vary markedly at certain periods of the year due to seasonal buying habits.
<b>Loan Proceeds</b>	If you will receive the proceeds of a loan, such as a line of credit, the amount will be shown on this line for the appropriate month. It is this line that would show the financing arrangement that you have made to cover any cash shortages.
<b>Cash from Other Sources</b>	This line accounts for any cash received that is separate to the proceeds of a loan or the monies directly generated by your business operation. This line could be used to show the sale of fixed assets and equipment or to show the proceeds of an additional investment from a partner or major shareholder.
<b>Total Receipts</b>	Here you put the total of all the cash anticipated to be received by the business during the month.
<b>Improvements, Fixtures, Equipment</b>	These are capital expenditures and should be shown in the month that payment for them will be made. Normally, these are disbursements that are not a constant monthly expense.
<b>Inventory</b>	This entry shows when the inventory purchased is to be paid for. It is not when the inventory is received, unless you are on a COD basis. Your inventory must be determined in relationship to your sales forecast.

Depending on your type of business, inventory purchases also can vary from month to month.

**Management  
Salaries & Taxes  
Employee Wages  
& Taxes**

These two entries include the income taxes and fringe benefits paid by the business on the employee's behalf. In principle, the owner's or owners' salaries are included as an operating expense. When determining the monthly amounts, keep in mind seasonal slack and peak periods or situations where an increased wage force is in direct relation to increased sales.

**Rent  
Mortgage  
Payment**

This is usually an either/or situation. Each month should include any interest or escalation charges as well.

**Heat, Light &  
Power  
Office Expenses  
Maintenance &  
Repairs  
Advertising  
Insurance  
Legal & Audit Fees  
Miscellaneous  
Expenses**

These form the bulk of your operating expenses. Again, your type of operation, location, etc. will dictate whether or not, and when, any of these expenses will vary. Insurance, as well as legal and audit fees, may be paid on a monthly basis throughout the year or may be a once only payment.

**Loan Repayment**

Here, you show the repayment of your loan — principal and interest. If the loan was for the purchase of a fixed asset, then the monthly payment will probably be a specified amount. If you have a line of credit, the repayments will more than likely vary each month.

**Income Taxes**

This is your estimate of what taxes will be payable and when. This line may be completed monthly or on a periodic basis if you pay taxes by installments.

**Total  
Disbursements**

This is the total of all cash anticipated to be paid out by the business during the month.

- Cash Surplus (Shortage)** Here, you show the difference between total receipts and total disbursements. If your receipts exceed your disbursements then you will show a surplus for the month. If the disbursements exceed the receipts then there is a shortage for the month.
- Cash on Hand — Beginning of Month** This is the amount of money available at the end of the previous month.
- Cash on Hand — End of Month** This is the amount of money at the end of the current month after adding the surplus to the beginning of the month line, or after subtracting the shortage from the beginning of the month line. This amount becomes the cash on hand — beginning of the month line for the following month.

**NOTE:** The **Cash on Hand — End of Month** line is the most important part of your forecast. If your estimate shows a negative balance, you will have to borrow this amount of money to meet your planned expenditures.

A cash flow forecast is to be referred to, and worked with, often. It is not just done once and then left in a file. To derive maximum usage, you should review and adjust each month to reflect any changes in either cash receipts or cash disbursements. These changes may be either in amount or in time.

Remember, a cash flow forecast to really help must be accurate and must be used. It is the most important tool that you have in cash management. As well as helping you in assessing cash needs, it may also be requested by a term lender when considering your proposal for a loan.

## CONCLUSION

A business can operate profitably and yet have difficulties because it is starved for cash at certain times of the year. Good cash management in the form of regular controls and a cash flow forecast will help alleviate this situation.

Instituting cash handling practices and checks or audits such as bank reconciliations allow you to keep on top of your daily cash activity. These are your regular controls. Your cash flow forecast predicts where and when cash shortages or excesses will occur. This allows you to plan ahead.

Cash is one of your business's most vital assets. It must be managed well.

## 10. GIVING CREDIT TO YOUR CUSTOMERS

*"The granting of credit has both a positive and negative side. Good credit management helps ensure the positive side."*

— CASE Counsellor

INTRODUCTION .....	116
THE ADVANTAGES OF OFFERING CREDIT .....	116
THE DISADVANTAGES OF OFFERING CREDIT .....	117
YOUR CREDIT POLICY .....	117
YOUR COLLECTION POLICY .....	121
CREDIT INVESTIGATIONS .....	122
THE CREDIT APPLICATION .....	125
A TEST OF PROMPTNESS .....	127
CREDIT CARD SERVICES .....	127
CONCLUSION .....	128

# INTRODUCTION

Credit has been defined as the ability to obtain goods or services in return for a promise to pay in the future. It is a sale on trust. But how can you be sure who, among your customers, is trustworthy, and who is not? There are ways to find out. How much credit should you extend to those you trust? Again, there are ways to determine such limits.

As a business owner or manager, you should be familiar with sound credit management principles and how to apply them to your own business practice. This is the purpose of our chapter.

## THE ADVANTAGES OF OFFERING CREDIT

The principal advantage of offering credit is that it increases sales.

Granting credit allows goods or services to be purchased by customers who would otherwise be unable to do so, or who would purchase the same goods or services from others willing to offer credit. Sales are increased not only by widening the customer base to include such customers among your clientele, but also by that group as an entity. These people who purchase on credit tend to buy more goods and services, and more frequently.

Customers to whom credit is given often develop a loyalty to the firm that has invested its trust in them. They will generally return to that firm first before making purchases elsewhere. The advantages of giving credit, therefore, are:

- increased sales
- increased customer base
- a competitive edge over businesses not granting credit
- customer loyalty

## THE DISADVANTAGES OF OFFERING CREDIT

The main disadvantage of offering credit is the cost to the seller.

When selling on credit, a business is giving away its product for only a fraction of its cost. Payment in full will not be received immediately, but the costs of producing the product must nevertheless be paid by the seller. The effect is the same as making a loan to the customer. Therefore, a greater amount of capital must be available to the business than would be required if operating solely on a cash basis. The cost of this capital is an added expense to the seller.

In addition to the cost of the greater amount of capital, there are the costs of determining which customers are worthy of credit, costs of maintaining records of amounts owing, and costs of billing and collecting. And no matter how careful you are in granting credit, there will likely be customers who will fail to pay; the resulting bad debt is yet another expense.

Other disadvantages to granting credit are: the higher rate of returns or exchanges of goods since customers who buy on credit are more likely to return the goods; overbuying of goods that the customer does not need and cannot afford; overselling by the seller. All these factors contribute to higher costs to the seller.

## YOUR CREDIT POLICY

You have weighed the advantages of offering credit to your customers against the disadvantages. You have chosen to offer credit. Where do you start?

You start with a policy which you can set for yourself and your business. Your credit extension policy should be neither too liberal, nor too restrictive. Too liberal a policy invites excessive receivables and uncollectible accounts while an overly restrictive policy can lose you potential sales.

A successful credit and collection policy requires that all problems be detected and dealt with as early as possible. Accounts that become too long overdue often become uncollectible.

## 1. Average collection period

An important indicator of the effectiveness of your credit and collection policy is your average collection period. The average collection period is a ratio that expresses the total amount of receivables outstanding in terms of an equivalent number of average daily credit sales.

The average collection period is calculated by dividing your accounts receivable by the average daily credit sales:

$$\frac{\text{Accounts Receivable}}{\text{Average Daily Credit Sales}} = \text{Average Collection Period}$$

Let us take an example. If a business has average monthly credit sales of \$12,000 and outstanding accounts receivable of \$18,000, the collection period would be calculated as follows:

$$\frac{\text{Average Monthly Credit Sales}}{30} = \text{Average Daily Credit Sales}$$

$$\frac{\$12,000}{30} = \$400 \text{ (Average Daily Credit Sales)}$$

Returning to the original equation:

$$\text{Average Collection Period} = \frac{\$18,000}{\$400} = 45 \text{ days}$$

This is the indicator. It shows that, on the average, customers are taking 45 days to pay their accounts. Other formulas used to calculate the average collection period consider only net sales. These are determined by subtracting an estimated allowance for bad debts from total annual credit sales.

Once your average collection period has been determined, it can then be compared with any of the following bases to spot a potential trouble source.

**Payment terms** If your terms of sale specify payment within 30 days and your average collection period is more than this, it indicates that creditors are not complying with your terms, and a problem exists.

**Past history** Comparison with results in past periods indicates whether collections are improving or declining.

**Industry averages** Comparison with the experience of other companies in your industry will determine whether or not your credit and collection policies are as efficient as theirs. Industry averages can be obtained through trade associations and government bulletins.

## 2. Keeping receivables in line

The same equation,  $\text{Average Collection Period} = \text{Accounts Receivable} \div \text{Average Daily Credit Sales}$ , can be used to determine if your receivables are excessive when compared with the industry's average collection period.

For example, assume that your terms of sale specify payment within 30 days, and that your industry average collection period is also 30 days. A suitable target for your receivables would then be 30 days' average credit sales. If your average daily credit sales are \$400, you could then calculate a target for receivables as follows:

$$\begin{aligned}\text{Average Daily Credit Sales} \times \text{Collection Period} &= \text{Accts. Receivable} \\ \$400 \times 30 &= \$12,000\end{aligned}$$

If your actual receivables were \$18,000, you would then know that you had an average of \$6,000 (\$18,000 — \$12,000) in receivables that must be dealt with on a priority basis.

How do you do this? You would immediately reduce the collection period, speed conversion of receivables to cash, minimize your capital tied up in accounts receivable and, in the process of doing so, reduce the risk of uncollectible accounts.

## 3. Set your terms

Your credit extension policy should specify the terms you are prepared to offer your customers, and what limits will apply. Those terms and limits should be clearly stated on the invoices you send to your customers. Is payment due within 10 days or 30 days? Are the days measured from the receipt of goods, receipt of the invoice, or the end of the month?

## 4. Cash discounts

If your credit-granting competitors are offering a cash discount to their customers, your credit extension policy should also include such an offering.

The cash discount, usually one or two percent, for payment within ten days, is usually indicated as follows: 2/10

The first number is the discount percentage: 2%. The second number denotes the number of days within which the payment must be made in order to take advantage of the discount. Thus the term, 2/10, means that the customer can take a two percent discount for payment within 10 days.

But this is 10 days from when? If the customer lets the discount period slip by, when is the net amount due? The answers are specified in the dating terms which can be noted as follows: 2/10 — n30

The n signifies net. The 30 denotes the number of days within which period payment is due. If no other date is indicated, the 30-day period begins with the invoice date. Thus, if the terms above were indicated on an invoice dated June 16, the customer would be entitled to a two percent cash discount for payment on, or before, June 26. If the customer does not pay within this period, the net amount is due within 30 days, or by July 16.

## 5. Monthly statements

You should send monthly statements to your customers to advise them of their account balances. The statement should clearly indicate the amount owed and show any transactions that have taken place in the account during the 30-day period.

If you choose not to use the invoice date as the beginning of the dating period, either one of two abbreviations, EOM (End of Month) and ROG (Receipt of Goods), should be clearly indicated on your invoice. EOM means that the discount and net periods begin at the end of the month, regardless of the invoice date. ROG signifies that the period begins when the customer receives the goods, regardless of the invoice date.

Returning to the preceding example, if the following was noted on your invoice: 2/10 — n30 EOM, the customer would then be entitled to a two percent discount for payment by July 10. If your customer chooses to disregard your discount terms, the net amount would be due July 30.

Your competition may force you to offer the same payment terms as they have; so before choosing a particular set of terms, find out what your competition is offering.

## **6. Delinquency charge**

In your credit extension and collection policy, you may wish to establish a delinquency charge for late payment. The purpose of this is to discourage your customers from allowing their accounts to become long overdue.

The delinquency charge takes the form of a service charge, expressed as a monthly percentage in line with current interest rates, on all balances more than 30 days past due. The charge should be noted as such in the monthly statement you send to your customer. Refer to the charge as a late payment rather than a delinquency charge.

## **YOUR COLLECTION POLICY**

A cardinal rule of good receivables-management is to minimize the time span between the sale and the collection. Any delays that widen the span cause receivables to grow to even higher levels, thereby increasing the risk of the account becoming uncollectible.

The best time to begin collecting long overdue receivables is always NOW. If the overdue account is difficult for the customer to pay off now, it will only be more difficult in the future if it is allowed to languish in your books.

You should, therefore, establish a firm collection policy, and stick to it even if it means upsetting a so-called good customer. No customer whose bills are rarely paid according to your credit policy is good. Don't worry about the customer not coming back should you press for pay-

ment of the outstanding balance. The customer whose account is cleared is more likely to return to do business with you again than the one who is badly in arrears. Don't be concerned about unreliable customers giving you a bad reputation because of your collection policy. Customers who are bad debtors will not want to reveal this fact.

It is unrealistic to think that you will not have bad debtors when you offer credit. You may be a good judge of character, but last year's good customer is as capable as you are of falling on bad times.

Take the case of Fred Krantz whose small snowshoe fabricating operation could barely keep pace with the demand for the handmade product. He made every effort to complete Marcel Gauthier's order simply because Marcel had been one of his first customers, and had doubled his orders every year for the preceding four years. Marcel ran a sporting goods store and ski repair shop at one of the busiest ski hills in the Laurentians.

Then this winter, what little snow fell was washed away by rains. Marcel's accounts, not only with Fred but with other suppliers, became delinquent. Had Fred been wrong to have extended Marcel so much credit? After all, Marcel had proved his reliability on previous orders. The answer is yes. Fred knows, as well as Marcel, what a poor winter can do to business. Fred knew Marcel, but did he know how prudently Marcel was running his business? If he didn't, he could have found out.

Our next section examines how the small business operator can obtain credit information.

## CREDIT INVESTIGATIONS

Three sources of credit information are available to the business owner without a credit department which could normally carry out a credit investigation. They are: Credit Bureaus, Better Business Bureaus, and Dun & Bradstreet.

**Credit Bureaus** In Canada since 1922, now have over 150 branches and a staff in excess of two thousand to provide businesses with consumer credit records of individuals.

Credit Bureaus basically confirm information that credit grantors (banks, mortgage companies, department stores, oil companies, finance companies, and automobile dealers) have obtained from individuals requesting consumer credit. Under Canada's consumer credit laws any individual applying for credit must do so in writing. When a consumer does this, he not only supplies information such as details of identification, present and past addresses, present and past employment, salaries and references to the grantor but, at the same time, agrees to his application being checked. The Credit Bureaus build up this information with reports of other credit requests by the consumer, turn-downs of credit as well as payment histories obtained from existing accounts where credit was granted.

Other information on the Credit Bureaus' files — not supplied from the credit grantors — is derived from the public record: judgments, non-responsibility notices, registered chattel mortgages, conditional sales, and bankruptcies.

Files are only opened on individuals when a request for information is received from a credit grantor or when something appears on the public record. The Credit Bureaus stress they do not grant credit; they merely advise and provide assistance to those in business to grant credit.

To use the Credit Bureaus' services, a business must apply to the nearest Credit Bureau and, depending on whether the business's market is local or national, take out a membership fee (\$25 or \$100). With the annual membership comes a special code number which allows the business to telephone the Credit Bureau and obtain verbal reports on individuals. A nominal fee is charged for each report. Written reports can also be obtained.

When information is already on file, the verbal report is instantaneous; otherwise, if a new file has to be opened the verbal report is generally given within 24 hours. Credit Bureaus in Canada are associated with their U.S. counterparts (3500 Bureaus) and in Europe.

Credit Bureaus point out that they provide counselling service on credit to businesses; that most bureaus issue a monthly bulletin which provides up-to-date information on the credit industry applicable to the local area; and that, while primarily their credit reporting pertained exclusively to individuals, retail and commercial concerns are now being filed (a different fee structure is applicable for retail and commercial reports).

**Better Business Bureaus** There are 14 in Canada, serving 68% of the market population, and incorporated as non-profit organizations — they do not provide credit information on companies or individuals. Instead they compile business reliability reports that include a grading system of 1-A to D.

Information in these reliability reports is mainly of two sorts:

- basic information which comes from the company itself
- information about how the company has handled complaints forwarded to it by the Better Business Bureau

These reports come into being through both outside initiative: information enquiries, complaints, public record, as well as internal initiative: a local Better Business Bureau contacting a company suggesting a voluntary listing in the bureau's files.

The Better Business Bureau, when complaints are received about a company, will vet the complaint, and then pass the complaint on to the company in question. The disposition of the complaint, whether adjusted, disputed, or rejected as unjustified, is tabulated on the company's reliability report and is the prime factor in setting the bureau's rating system on a company.

A rating of 1-A means that no complaints have been received on the company; an A rating shows that a company examines and adjusts a large majority of valid complaints; B rating means the company has only 50-60 percent rate of adjusting valid complaints; both C and D indicate that the company does not meet the bureau's standards.

Though the Better Business Bureau invites companies to become members of its organization, anyone can request a verbal reliability report. Reports are available both on member and non-member companies. The bureaus in Canada are in contact with nearly 150 Better Business Bureaus in the United States.

**Dun & Bradstreet Canada Limited** Eleven offices across the country which provide credit and financial reporting in the form of Business Information Reports and the D & B Reference Book.

Dun & Bradstreet business reporters gather and interpret essential credit background information on the management and activities of manufacturers, wholesalers, retailers, and business service industries. The

information obtained includes the history, operation, payment record, finances and banking of a business; all of which is summarized into report form and used as the basis for assigning a rating on the credit-worthiness of the business.

The majority of this information is obtained voluntarily from businesses themselves. Most companies recognize that it is better to supply Dun & Bradstreet with full and accurate information resulting in a correct rating than run the risk of their file not being complete or current. Additional information is obtained from banks, suppliers to the company, and the public record. Once a file is opened on a company it is kept in a process of update.

The Dun & Bradstreet rating is composed of two parts: (1) estimated financial strength, and; (2) composite credit appraisal. The estimated financial strength of a company is shown as being between a minimum and a maximum bracket (example: rating DD \$35,000 to \$49,999). The composite credit appraisal, divided into classifications of high, good, fair and limited, represents an assessment of a company's credit-worthiness that has considered such factors as management, survival and growth ability, and payment records.

The D & B Reference Book, which is revised every two months, is a listing of over 380,000 Canadian businesses. Each listing includes the business name, year started and D & B rating. The Reference Book has been designed as a convenient source of preliminary information to check small orders, set up credit lines based on ratings, and to note business changes with customers and prospects.

A business wishing to use the services of Dun & Bradstreet must take out a yearly subscription. This entitles them to verbal and written Business Information Reports on companies (75% of requests answered immediately from files; reports sent on the balance of enquiries within one to six days) and the D & B Reference Book.

## **THE CREDIT APPLICATION**

There's a fourth source of credit information you should refer to even before you consult the previously mentioned outside sources. That is the credit application itself.

A credit application should tell you three things you must know before you grant the applicant credit:

- the applicant's ability to pay based on income and obligations
- the applicant's reliability in meeting credit obligations
- the potential profitability of the account. You stand to lose your cost of the product or service if your customer cannot meet payments. If your cost is relatively high compared to the selling price, then you have to obtain as many facts about the applicant as you can.

For individual applicants, you should know the following:

- employment history
- current occupation
- current income
- length of time in current occupation
- security of the job
- monthly expenses such as rent, utilities, food budget, etc.
- bank balance
- personal possessions such as house, car, investments, etc.
- credit standing
- amount of credit requested

Information on the first five will likely give you a good insight into the three C's of the applicant's credit-worthiness: character, capacity, and capital.

If the applicant is employed, his or her immediate supervisor, or a personnel supervisor, can reveal details about the applicant's character and capacity (ability to assume obligations, financial and otherwise). The applicant's banker cannot divulge details about the applicant's bank balance, but can discuss the credit-worthiness of the applicant as it relates to his or her performance in paying off past or present bank loans.

You should feel free to ask why the applicant needs credit. If it is due solely to a cash shortage, and your investigation reveals that the applicant has held a steady job and has met all financial obligations in the past, then that person is likely to be an excellent credit risk. If the applicant is short of cash and is overextended elsewhere, this indicates a poor risk.

There are no infallible guidelines to spot good or poor risks. There are poor people who always pay their bills, and there are rich people who do not. A combination of facts and figuring will point the way; if hunches in the past have proven to be right, keep responding to them.

## A TEST OF PROMPTNESS

In agreeing to grant credit to an applicant, you should explain clearly your policy terms, and you should set a credit limit **based on the customer's ability to pay**. A cash down payment on certain types of merchandise is a practical deterrent to unnecessary or excessive purchases.

A test of promptness in meeting your terms begins with you, the creditor. A delay in sending your invoices will likely be met with a delay in receiving payments. You will set the example of promptness with your customers. If you neglect to apply a delinquency charge, your customers will likely neglect to get their payments back in line. Firmness will bring results.

## CREDIT CARD SERVICES

If you are managing the kind of business that has a large number of relatively small accounts, credit arrangements for customers are available through use of credit cards. Two major credit cards are offered through Canadian banks. There is, of course, a charge to the seller for the use of the credit card system. This is expressed as a percentage of the sale. The percentage will vary depending on the overall volume of sales that you have.

Credit card services eliminate the need for credit approval, invoice preparation, record maintenance, and collections. They also minimize your commitment of capital and virtually eliminate the risk of uncollectible accounts. From a marketing standpoint, the availability of instant credit often encourages a customer to buy immediately rather than postpone a decision to buy, or dismiss the impulse completely.

## CONCLUSION

Buying on credit is very much a part of the Canadian economy and has become a major factor in doing business. Therefore, all businesses at some time will have to consider the granting of credit.

Yes, there are risks to giving credit, but the rewards will outweigh them if you establish a sound extension and collection policy that is tailored to the needs of your business. Once the policy is established, **you** must adhere to it or your customers will not.

# 11. PAYING YOUR EMPLOYEES

*"How you pay your employees is a reflection on their performance and the performance of your business."*

— CASE Counsellor

INTRODUCTION .....	130
PREPARE A POLICY .....	130
THE POLICY .....	132
FROM POLICY TO PRACTICE .....	133
REASONS FOR RAISES .....	136
COMPUTING A PAY RAISE .....	139
CONCLUSION .....	142

## INTRODUCTION

The most sensitive issue in business is employee recognition. You recognize the contributions of your employees in two basic ways: praise (positive feedback) and pay. Often the former can be a substitute for the latter, but not for long. An employee who is underpaid and overpraised will put up with the situation where genuine self-sacrifice is called for, such as when sales nosedive due to an unexpected crisis imposed by external economic conditions. But when a business is prospering, as most should, employees will also expect to prosper. Failing to recognize them by paying them wages and salaries that reflect their contributions to that prosperity will lead to a downfall — in morale and productivity.

What you pay your employees is more than a reflection of their performance, however. It is a reflection of business conditions. And you should be as aware of these business conditions as you are of the employees' performance.

## PREPARE A POLICY

You often hear employees complain of being overworked, but seldom of being overpaid. Like their employers, they mentally relate the work they put into the job to the remuneration received. Most employees know when they are being fairly paid for their labours; but when they feel they are being poorly paid, they often retaliate by performing lackadaisically, arriving late for work, taking long coffee and lunch breaks, and frequently phoning in sick.

Formulating a wage and salary policy and making employees aware of it can prevent a decline in morale and productivity.

Jack Baker paid the price for not having such a policy. He owned a shoe store in a small Ontario town, and had the good fortune of having Fred Kealy as an assistant. Where Jack was inclined to worry, Fred was carefree and always jovial with the customers. His joviality took a nosedive when Jack hired Karen Harwood, fresh out of high school. Fred felt that his special position in the business was threatened, but within days he too fell under the spell of Karen's bubbly enthusiasm for people pleasing as she called it.

Business was brisk that summer and fall. At Christmas, Jack privately gave Fred and Karen an envelope with a Christmas bonus as a way of thanking them for their efforts in increasing sales to over 12 percent above the previous year's record.

A few days later, Karen told Fred what she had bought with her bonus, and it occurred to Fred that she had been given the same amount as he had, and once more he felt a sense of betrayal. After all, she had only begun in June, five months short of a full year, and yet had been given the same amount that he had received for a full year's effort.

Fred finally built up enough courage to complain to Jack.

"I don't think it is fair," said Fred, "Karen got the same amount of bonus as I did. She's had no previous experience; she's half my age, and she's been here for only seven months."

Jack was perplexed as to what to reply.

"I don't pay a bonus based on a person's years, experience, or age. Karen was paid not only to sell but also to do the window displays. Those two jobs are equivalent to a year's work. Don't forget your salary is higher than hers."

Fred didn't say anything more, but he remained unhappy for three or four weeks. Jack resented the suspicion of favouritism and wondered if he had given enough thought to the whole question of remuneration for employees. Maybe he should establish policies that would avoid problems such as the question of a bonus.

Policies — written and adhered to — not only avoid employee-management problems, they also establish the rules of the game. If everyone knows the rules, the game can be played as it should be.

## THE POLICY

Wage and salary policies should contain neither generalizations like “Top dollar for top work”, nor specifics such as actual amounts like “Up to \$20,000 plus commission for all sales positions”.

A policy can be summed up in one or two clearly worded sentences.

For a small firm, a policy might resemble that of O’Connor Clothes. Owner and manager, Stan O’Connor, drew up this policy when he hired the first of the four employees he brought into the business.

It reads as follows:

### **O’Connor Clothes**

“Wages and Salaries: It is the policy of O’Connor Clothes to pay its employees the average of rates for similar work in this community, to comply with all applicable wage legislation such as minimum wage and vacation pay legislation and to review wages and individual performance at least once a year.”

At first glance, the wording seems trite, but note a few key phrases: average of rates, similar work, comply with ... minimum wage ... legislation. O’Connor Clothes doesn’t pay higher than average wages; it pays average wages — as a matter of policy. It doesn’t pay as well as any employer in town; it pays the average for clothing stores in town — as a matter of policy. It pays above the minimum wage and is committed to do this if the minimum wage increases — as a matter of policy. It considers raises, based on how well the employee does his or her job, at least once a year — as a matter of policy.

Stan O’Connor’s policy, stated in writing, clears the air — for himself and his employees. There can be no clouds of suspicion. It is there in black and white.

## FROM POLICY TO PRACTICE

Having a wage and salary policy is like having a car in your garage representing your transportation policy. Putting it to use is the real measure of its worth.

Like a car which is the embodiment of up-to-date engineering and design principles, a wage and salary policy is the embodiment of current principles of remuneration, among them:

**The going rate** — what the competition is paying for similar work. If you offer less, expect to get less qualified employees, or less productivity from them.

**Legislated rates** — what governments decree that you must pay (minimum wage, vacation pay, termination pay).

**Job description** — the duties the job entails. More duties generally mean more pay.

**Job evaluation** — the worth of each of the duties the job entails. Specialized skills command a higher rate than general skills.

**Performance appraisal** — how the employee performs relative to the job description and evaluation.

**Wage and salary revision** — when forces beyond your control — government regulation, union settlements, or competitors — raise wage rates, you must revise yours accordingly.

Knowing these principles, let us see how they should be applied to actual pay practices.

**The going rate** As a business owner, it will not take you very long to find out what your competitors are paying for similar work. Your employees will let you know. Where matters of pay are concerned, they keep themselves informed. But always verify an employee claim such as, "They're paying thirty percent more at Oswald's across town." Check with Oswald's to confirm. As well, call two or three other businesses comparable to yours. If you're shy about making a direct inquiry, keep your eye on the employment ads in your newspaper. Your competitors will often include the salary range for the job they are advertising. Clip

the ad out for future reference. Other sources of information on salaries are your Board of Trade which publishes annual wage surveys, and your provincial departments of industry, trade and commerce.

**Legislated rates** You are dissatisfied with the employee you hired three weeks ago. What termination and holiday pay do you owe him? Your provincial government has very specific policies governing such situations. You can find out by getting onto the mailing list of the Canada Department of Labour which publishes "Labour Standards in Canada", a booklet detailing minimum wage rates for all provinces, including pending changes in such rates. Also consult your provincial labour relations authorities.

**Job description** In small businesses, these can be written on a single page. In large businesses, they can stretch to ten pages. Ideally, job descriptions should include, in addition to the duties involved: a general description of the function to be performed; a definition of the authority which the job is given in order to achieve its objectives: reporting relationships to you directly, or to your second in command; standards of performance, e.g. incumbent must close an average of five sales a week.

**Job evaluation** Is a typist who types twenty business letters a day worth more or less than a bookkeeper who comes in only two days a week to perform an equally necessary function? In small businesses with only three or four types of jobs, the owner can rank them reasonably accurately. In larger businesses, a point system is used.

**Performance appraisal** Performance appraisals are both informal, and formal. Informal appraisals involve day-to-day contact with the employees during which you, the manager, can observe their strengths and weaknesses as they perform their duties. Improvements can be suggested on the spot but this should always be done in private. At least once a year, generally on the anniversary of the employee's employment date, you should make a formal appraisal. On that occasion, the employee's performance is measured against his or her job description to determine how effectively the duties are undertaken. The appraisal should record the strengths of the employee as well as the weaknesses, so that next year's appraisal can focus on the efforts to overcome these weaknesses.

**Wage and salary revision** Occasionally external factors beyond your control will oblige you to revise an employee's salary to reflect changing conditions in the workforce. The government might revise its minimum wage rate, or the largest employer in town might suddenly advertise for welders at rates twenty percent higher than what you are paying. In the latter instance, you are not obliged to revise your welder's salary to match your competitor's, but failure to make some comparable adjustment in direct wages or fringe benefits could lead to problems with your employees.

How would Stan O'Connor apply these principles in his pay policy towards his employees?

Let us take the case of Doris Vines, Stan's most experienced saleslady. Doris joined O'Connor Clothes five years ago as a salesperson, having previously worked at Eaton's in the town's major shopping centre. She is now paid \$180 per week, or \$9,360 per year. It is time for Stan O'Connor to review her performance over the past year. How might he do this?

Let us listen in on their private exchange.

"Doris," says Stan genially, "you've been a great help during the past year. Always ready to pitch in. I hear the sales people at Eaton's got a raise."

"Going to match it?" she asks.

"Better than that. I'm going to go one better. But it will require that you take on an additional supervisory role. Interested?"

"Well, being the senior salesperson here, I've always tended to Mother Hen them, sometimes to the point of ruffling their feathers. So I'll be glad to have my role formalized, so to speak."

"Well, for your new responsibilities, I'm offering you \$40 more a week. How's that sound?"

"It sounds great," she replies.

It's all there: the going rate, wage and salary revision, job description, job evaluation, and performance appraisal.

Doris was given a raise based on a change in the prevailing rates in the job market, her own good performance during the past year, and increased responsibility.

The principles of a sound wage and salary policy were put into practice. And a sound employer-employee relationship continues.

## REASONS FOR RAISES

Raises can't be given in a spirit of generosity. Not even Santa Claus gives gifts to those who haven't deserved them. He only rewards for good behaviour. But an employer must take other factors than just good behaviour into consideration before he passes out his annual gift of a pay raise.

In brief, they are:

- the ability of the business to pay increased wages
- the basic job requirements
- internal pay relationships
- performance
- cost of living trends
- supply and demand for employees
- rates of pay in other organizations
- wage indices and trends

Let us take a closer look at these considerations.

**The ability of the business to pay increased wages** Wages are paid out of the business's revenues. If raises are to be given, there must be at least a proportionate increase in the business's sales volume or its prices, or a proportionate decrease in operating costs. In a company where machines rather than people do most of the work, such as a photocopy firm, the wages of the firm might account for 10 percent of the cost of the product. A 10-percent wage increase would add one percent to the production cost. In a service business, such as a travel agency,

wages might account for 80 percent of the firm's cost. A 10-percent wage increase would raise costs by eight percent.

**The basic job requirements** What does the job require of the employee, and what are the requirements worth to the success of the business? A specialized skill commands a higher wage than does a generalized skill. The employee who can repair television sets, as well as sell them, should be paid more than the employee who only sells them. Why? Because the former brings two skills to the business: technical and sales.

**Internal pay relationships** What is the relationship of one employee's pay to another in the same business? Should the salesperson who brings \$40,000 in sales to the firm be given a greater raise than the delivery person who brings no sales to the company, but renders a necessary customer service with cheerfulness and enthusiasm?

The dilemma is not impossible to solve. All the employer needs to do is to appraise each employee's performance. If each has performed to capacity, they each get a similar raise, say 10 percent. The amounts will vary obviously, but the increase will be fair to both.

**Performance** Always keep in mind that you appraise an employee's performance in terms of his or her job description, not in terms of the performances of others in the company. The delivery employee might not have contributed directly to sales, so there shouldn't be any judgment relative to these other employees. But the delivery person might have boosted customer relations with an obliging manner, and that's an indirect contribution to sales. Satisfied customers will keep patronizing the firm.

When an employee performs well in terms of the objectives laid down in his or her job description, but is now at the top of the pay range for the particular job, it is time to consider a promotion to another job or to more senior responsibilities within that job classification. This is what Stan O'Connor did with Doris Vines.

Where performance cannot be rewarded with a promotion, you may wish to consider giving the employee a bonus. A bonus should be awarded on the basis of the business's profitability and the employee's contribution to it.

**Cost of living trends** In recent years, cost of living allowance (COLA) clauses have been written into union-negotiated contracts, and non-unionized employees have come to expect that the same factor be included in any pay raise, irrespective of performance. But if the cost of living increases 10 percent in a 12-month period, the employee who has performed indifferently should not expect to get an automatic increase of 10 percent. High wages for low productivity is a major cause of inflation and the ever-increasing cost of living.

**Supply and demand for employees** One of the rules of the marketplace is that prices go up when supplies are limited, and fall when supplies are plentiful. But in the job market, this law doesn't necessarily apply. An employer may offer a high salary for a job and still get few applicants. On the other hand, minimum wage regulations will prevent him from lowering the wage for a job that fifty eager applicants desire. When the salary that the employer offers does not draw interested applicants, it should be either increased or, if that is not possible, the job description should be revised to include attractive fringe benefits in lieu of salary.

**Rates of pay in other organizations** When comparing rates of pay with those for similar jobs in other businesses, make sure that the businesses are similar in most ways. You cannot compare a unionized plant with a non-unionized plant, nor a 10-employee manufacturing firm with a 10-employee retail firm. The wages of the key employees in each business often affect the wages of the support staff, so that a typist in one kind of business may receive a wage much higher than that of a typist in another business which offers a very different kind of product or service. The employer should be aware of pay rates in similar businesses, but shouldn't slavishly match them unless employment conditions are absolutely identical.

**Wage indices and trends** These are publicized in a variety of government and institutional reports. It can be helpful for the small business person to know the forecasted wage trends for particular segments of the workforce. If a steep rise is forecasted within the months ahead, now may be the opportunity to consider an increase in wages to ensure loyalty.

## COMPUTING A PAY RAISE

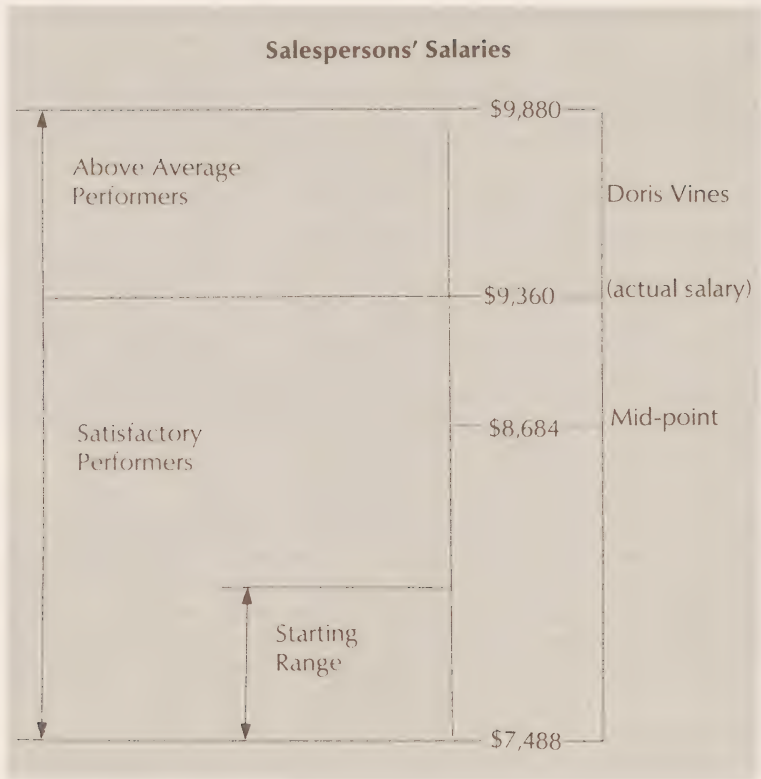
How do you decide on the exact amount of an individual pay increase?

If you have done the kind of investigation previously suggested (i.e. compared wage rates for similar jobs in similar organizations, checked the sources forecasting the anticipated cost of living, and the supply and demand for the kind of skilled workers you require for your firm's successful operation) you are ready to conduct private performance appraisals with each employee on your staff.

Let us return to O'Connor Clothes. There we learned that Stan has obtained figures on actual salaries paid to salespersons by five employers in his community. They ranged from \$3.60 per hour to \$190 per week. In all cases, the work week was 40 hours. Stan converted these figures to annual salaries because all his budget figures and other financial data were expressed in annual figures. The wage range that emerged ran from \$7,488 to \$9,880 with a mid point of \$8,684.

Stan interpreted this as meaning that starting rates clustered toward the bottom of this range, that those who did an average job would likely progress from the starting to the middle point, and perhaps higher, and that a salesperson who showed above-average performance should be paid a wage near the top of the range. He also knew that such a range would gradually change, likely upward, and that the whole range would need to be reviewed at least every year.

In essence, he had this picture:



What factors did Stan have to consider in revising the wage and salary of Doris Vines? The first one was her added responsibilities. If she was to take on a supervisory role over the other salespersons, she would no longer be doing the same job as they were. She would be doing more, and therefore, should be paid more. Stan got Doris to agree to have three more duties added to her job description:

1. supervises the quantity and quality of the work of all the salespersons
2. trains new salespersons
3. reports to me on the work of all salespersons

Stan also changed the job title or classification to: sales supervisor.

As far as Doris' performance was concerned, Stan regarded it as above average. Stan reasoned that based on her new responsibilities, performance, and comparisons with other employers, her salary should be above the top of the range paid to salespersons, that is \$9,880, by at least eight to ten percent. She had not received a pay increase for 12 months, and during that time the Consumer Price Index had increased by nine percent. Unemployment in the area had practically disappeared because of the opening of a new radio and television assembly plant. Stan realized that he needed Doris Vines on his staff, and even though she was already the highest paid of his salespersons, she should receive the promotion and pay increase.

Stan had to consider other factors. Ten percent above \$9,880 would be \$10,868. This would be slightly more than 16 percent over Doris' present rate of \$9,360. Stan wondered what would happen if all his costs were to rise 16 percent per year. He certainly couldn't increase his prices that much. Doris needed a nine percent increase just to catch up with inflation. He realized that income taxes would erode part of her increase, too. She had no formal experience in supervising, so would have to begin at the lower end of the salary range for sales supervisors. Granting Doris a \$40 per week raise which is a 22.2 percent increase over present salary seems excessive, but not in light of the increased responsibilities she will assume. It is the kind of raise that not only will motivate her, but will likely lead to increased sales by her staff as a result of her imparting to them her renewed enthusiasm and dedication.

## CONCLUSION

All businesses, whether large or small, should have a written, clearly worded wages and salary policy accessible to all employees. Initially, the owner/manager will determine the policy. As the number of employees grows, the policy may be revised through collective bargaining.

The small business owner must take into consideration eight factors when determining the extent of pay increases. They are:

1. the ability of the business to pay increased wages
2. the basic job requirements
3. internal pay relationships
4. performance
5. cost of living trends
6. supply and demand for employees
7. rates of pay in other organizations
8. wages indices and trends

The first four are internal factors; the last four, external. Keeping these factors in mind when applying the principles of a wage and salary policy to individual cases will pay off in terms of good employee relations.

## 12. PERSONNEL RECORDS

*"A good system of personnel records will show, on any day, accurately and quickly the number of employees you have, who they are, what job each one has, how much each one earns, and where each employee is located."*

— CASE Counsellor

INTRODUCTION .....	144
WHY KEEP PERSONNEL RECORDS? .....	144
WHAT ARE PERSONNEL RECORDS? .....	146
KEEPING PERSONNEL RECORDS UP-TO-DATE .....	153
RETAINING PERSONNEL RECORDS: FOR HOW LONG? .....	154
CONCLUSION .....	155

# INTRODUCTION

Just as a bill of sale is created the moment you sell some merchandise or a service, a personnel record is created the moment an employee is hired. And like bills of sale which identify the item or service, the date of sale, and the amount of the sale plus sales tax if applicable, personnel records identify the new employee and record the date of the person's entry into the firm, the amount to be paid in wages or salary, and personal income tax exemptions.

This chapter examines personnel records by dividing them into three distinct sections: general files, personal files, and the payroll record. As well, we look at the reasons for having personnel files and the requirements for their retention.

## WHY KEEP PERSONNEL RECORDS?

Why should you, a business owner, keep personnel records? There are two major reasons:

- sound business practice recommends that you do
- governments **insist** that you do

Because you must keep personnel records, it makes sense to organize a system that serves your purposes as well as those of your employees and the government.

Amber Ogilvy, owner of Forever Amber Fashions, prided herself on her memory, and she had reason to do so. She could remember the wholesale prices she had paid for a particular manufacturer's blouses six years ago when she opened her boutique. She could remember the amount of the loss she took when she overestimated the demand by her clientele for peasant-look ensembles.

Despite her memory for prices, profits, and losses, Amber couldn't remember everything, even though she thought she could. This was proven when Judy Garrett, her top salesperson, turned petulant toward her in late June, and remained that way for days. Amber finally took her aside to ask what the problem was.

"Well," said Judy sulkily, "I was hoping you would announce my raise. It's been three weeks, now."

"Three weeks? What has been three weeks?"

"Since my fifth anniversary of the day I joined up with you."

"Why didn't you remind me? I've been so involved with ordering for our fall line, I completely forgot."

"Well, you always hate to be reminded of things. But I did think you'd remember my anniversary. You did last year."

"Well, I can't be expected to remember everything all the time!"

No, she can't. That's why she should have made a record of it. Not only has she disappointed her best salesperson who was hoping for an acknowledgement of her fifth anniversary, but she has also missed conducting a performance appraisal to coincide with the anniversary of the starting date of her employee. This was a habit that Amber had always managed to keep until now. As well, Judy has not been informed of the amount of her raise, which is generally revealed at the conclusion of a performance appraisal.

Another reason for keeping such records is that both provincial and federal governments require that an employer maintains clear and complete personnel records. A typical directive from a government department dealing with employees and employers reads in part:

"An employer \_\_\_\_\_ shall make and keep, or cause to be made and kept, for a period of at least \_\_\_\_\_ months after work is performed by an employee, a record of the name, address, wage rate, vacations with pay or payment in lieu of vacations, hours worked and actual earnings of the employee and such other information as the regulations may require."

A final reason for keeping personnel records is that you might be asked to give a reference concerning the work history of an employee who worked for you three or four years previously. You might be asked

by your Board of Trade to provide data on employee turnover in small businesses like your own, or for information on salary and wage scales in your organization.

## WHAT ARE PERSONNEL RECORDS?

For ease of reference, we have divided personnel records into: **general files**, **personal files**, and **payroll records**.

### 1. General Files

General files comprise files on such topics as recruiting, training, manpower planning, salary administration, forecasts, budgets, and benefit plans just to mention a few. They should be accessible to any employee seeking information on such topics. Simple file folders can be used to contain material either drawn up by the employer (e.g. policies on specific subjects such as wages and salaries) or received from various government agencies. A brochure describing imminent shortages of manpower for selected skills and trades should be retained in the manpower planning folder for future reference.

The size and scope of the general files depends on the attitude of the employer towards storing information. Some employers like to keep bulging files on every business subject just in case, which might be a hoped-for invitation to speak to members of the local Chamber of Commerce, or to deliver an address at an assembly of high school students on Business Day.

Other employers prefer to keep information stored in their heads, then discard the material after a quick glance. This could become an unsound business practice.

Time is more expensive to a business person than a filing cabinet. Retaining information in the general files might prove to be more time-saving than making hurried telephone calls or writing letters to government departments or business organizations asking them for information they have already sent to you.

## 2. Personal Files

These files contain confidential information on employees. Unlike general files, personal files must be kept under lock and key so as to ensure the employees' rights to privacy. The law also states that an employee has the right to see his or her own personal file. Personal files must also be kept for government purposes.

A personal file can contain:

**Correspondence** A letter to the employer requesting employment; reference letters; a letter from a doctor advising the employer to grant the employee sick leave; a letter from the employee to the employer registering a grievance.

**Documents** Photocopy of the employee's birth certificate; transcripts of high school, junior college, or university grades; photocopy of the employee's driver's license (when the employee uses his or her own vehicle or the firm's vehicle on the job).

**Photo** Generally, a duplicate of the photo which appears on the company identification card.

**Job Description** For the owner of a business with fewer than five employees, a job description mainly comprising a list of the employee's duties can be written on a single sheet of paper. A job description is necessary for the employer and employee. This ensures that there is no misunderstanding about what is expected of the employee. A job description is used as a reference for determining the quality of the employee's performance in carrying out the duties listed.

**Performance Appraisals** Performance appraisals, generally conducted on the anniversary of the employee's first working day, contain evaluations — from poor to good to excellent — of performance relative to the duties listed in the employee's job description. Performance appraisals should not only evaluate past performance, but should set new goals for the year ahead. They should be retained to determine whether or not the employee has performed effectively in meeting those goals.

**Application for Employment Form** Small business owners often prefer to avoid the formality of filling out an application form. They simply hire on the spot, judging the applicant on appearance and person-

ality. But failing to check the oral claims of previous work experience could lead to on-the-job conflicts. For example, the owner discovers that the applicant can, in fact, type, but too slowly for the requirements of the position. Checking with the employer of the firm where the candidate claims to have worked will quickly reveal the competence of the applicant. If an owner decides to draw up a form, to be photocopied, and then handed to applicants when they present themselves, it must be kept in mind that government fair employment regulations serve to eliminate job discrimination against non-Caucasians, females where they are able to perform the duties of a traditionally male-dominated position, the mature job-seeker, the handicapped, and members of minority religions within the community.

The owner is entitled to information concerning the applicant's name, mailing address, telephone number, social insurance number, education, and work history.

**An employment record (card or sheet)** The purpose of this kind of record is to have readily available each employee's name, address, social insurance number, and job and wage record. When the employee's job, location or wage rate changes, the record should be updated. Though this kind of record can be kept on cards in a file box, a regular 8 1/2" × 11" sheet is more convenient because it contains more space for recording changes, and it fits neatly into a regular file folder. Should you design such a sheet for your personal files, remember that there are three main changes of status which can occur during a person's employment. An employee may:

- change duties
- relocate within the organization
- end employment (resign, retire or be terminated)

Ideally, on any given day, your records should show how many employees you have, who they are, what job each has, and where each is located. Obviously, it is easy to keep such information accurate and up-to-date if you have only five employees at one location. It becomes more complex if you have fifteen permanent and six temporary employees at two locations, as well as a high rate of staff turnover. But such complexity is the very reason for maintaining personal files. It eliminates mental recall, and ensures accuracy when reviewing the work history of employees.

Here is an example of the kind of employment record sheet that a small business owner could devise for use in the personal files.

**TYPICAL SMALL BUSINESS  
Employment Record**

Family Name: .....	First Name .....
Address: _____	_____
_____	_____
_____	_____
Telephone: _____	_____
Social Insurance Number: _____	_____

<b>Education</b>	<b>Work History</b>
------------------	---------------------

Date	Job Classification	Location	Wage/Salary	Remarks
------	--------------------	----------	-------------	---------

### 3. Payroll Records

Some of the information to be found in the employee's personal file must also be entered in another kind of personnel record: payroll records.

There is a large variety of payroll forms and stationery available to businesses, but the main objectives of all payroll records are:

- to calculate the gross pay (regular and overtime) for each employee before the end of each pay period, the deductions to be made by the employer as required by law (e.g. employee income tax instalments) or by the authorization of the employee (e.g. employee contributions to a savings plan or a charity fund), and the net pay
- to pay each employee his or her net pay at the end of each pay period (e.g. every two weeks or twice monthly)
- to maintain a continuous permanent record of all payroll transactions, including individual changes in pay rates

Whichever format your payroll records take, the following information about the employee must be entered:

- complete identification of employee — name, address, social insurance number, date of entry into your organization, personal income tax exemptions
- pay period (e.g. every second Thursday)
- gross salary
- net salary
- deductions — the most common payroll deductions are:
  - provincial and federal income tax instalments
  - government pension plan contributions (federal and Quebec)
  - contributions to employer's pension plan
  - unemployment insurance premiums
  - contributions to group life insurance plans
  - contributions to medical insurance plans
  - union dues

- payroll savings plans
- contributions to charity appeals

Almost eight percent of businesses in Canada have less than a dozen employees. The owner, therefore, can devise a fairly simple, inexpensive payroll records system. We illustrate two forms that could be used by the small business person. One is a **payroll sheet** which is completed for each employee; the other is a **payroll summary sheet** completed at every pay period.

If the business were to increase the number of employees, or if the owner becomes too occupied with other matters relating to the business's growth, payroll services offered by banks and other similar firms can be used at generally reasonable rates.



## KEEPING PERSONNEL RECORDS UP-TO-DATE

Keeping records up-to-date takes time; but on the positive side, it saves time. An example of saving time is when you need up-to-date information immediately and you do not have to take time searching for it or checking its accuracy.

Ensuring that your records are **clear, complete, convenient**, and **confidential** will go a long way in helping you keep up-to-date. Your records should be:

**Clear** Is the address that is scribbled on this scrap of paper your employee's old address or new address? It will be clear if you have devised an employment record sheet that contains space for more than one change of address.

**Complete** If you were forced to discipline an employee for an infraction, jot down the complete details of the act, and the action you took as a corrective measure. You might need the details if the employee files a complaint with a union or the provincial ombudsman or human rights commission. Your records might indicate your fairness in your handling of the incident.

**Convenient** Records are designed to serve, not sink you. If you devise your own forms, make sure that they contain as much information on a single sheet as possible, to save you from having to add more sheets. Example: as mentioned above, making space on an employment record sheet for changes of address will save you from having to devise a change of address form.

**Confidential** Most information about your employees is personal, so keep your personal files under lock and key.

Governments, as we have noted, require that the employer maintain personnel records. If a government department (Ministry of Labour) or board (Workmen's Compensation Board) were to ask for copies of

the personnel records of one of your former employees, would the records be complete? If not, would you be able to recall specific details of the employee's work history in order to make them complete? On such occasions, you might find yourself wasting precious hours, even days, getting information on the employee that would have taken only minutes to record when the changes in that person's wages and work routine took place.

If you, the employer, do not have the time to keep your personnel records up-to-date, delegate the duty to someone who has the time.

Keep in mind that updating records is almost always done in conjunction with another activity that involves having an employee's personal file before you. At the time you appraise an on-the-job performance, and inform the employee of the changes in duties and salary or wages, simply record the changes on the appropriate sheets in the file. It's that simple and quick. You are prone to error if you do not immediately record changes in wages or a job classification.

## RETAINING PERSONNEL RECORDS: FOR HOW LONG?

What should you do with personnel records that you no longer need? You will eventually destroy them; but only **after** you have confirmed that they are obsolete.

When an employee leaves your business, don't immediately destroy that person's file. Simply switch it to an inactive file. There are many reasons that it should not be destroyed immediately. These include requests for references, year-end income tax returns, enquiries from the former employee and, most importantly, laws from the governments stating the periods of retention. These periods of retention specified by the governments can range from one to five years.

An inactive file should only be destroyed when you are permitted by law to do so. Once you have established the date that the file can be destroyed, write that date on the file where it is clearly visible. That will help you weed out a file when you come across it after the date it was to be destroyed.

Records of job applicants are another story. If you interview fifteen applicants for one job, you will likely have fourteen forms that aren't of long-term interest. Your interview notes and references or other materials submitted by the applicants might be attached to the form. Some of the material might have to be mailed back to the applicants. If you wish to keep some of the applications for consideration for other jobs in the future, insert them in a file labelled promising applicants or whatever you feel describes them best. Keep the others in a file denoting rejected applications for no longer than a year. Applicants who re-apply over a year later should be asked to fill out new forms.

## CONCLUSION

As a good manager, you will wish to be in control of all your assets. Assets include your personnel. So keeping control of, and monitoring, this asset called personnel will mean a certain amount of record keeping. This record keeping, or personnel records, is both a necessity and a legal requirement in operating your business. Keep your records clear, complete, convenient, and confidential so that they will serve their purpose — and yours.











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# FINDING YOUR OWN BUSINESS

VOLUME 2

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Planning the start of your retail business .....	7
Financing for your retail business .....	33
Retail pricing .....	57
Managing your retail inventory .....	79
Attracting and keeping your retail customers .....	105





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# **MINDING YOUR OWN BUSINESS**

**Volume 2**

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# CONTENTS

FOREWORD .....	5
CHAPTER 1 Planning the start of your retail business .....	7
CHAPTER 2 Financing for your retail business .....	33
CHAPTER 3 Retail pricing .....	57
CHAPTER 4 Managing your retail inventory .....	79
CHAPTER 5 Attracting and keeping your retail customers ...	105



# FOREWORD

Each year, more and more people in Canada become small business entrepreneurs. The majority of these new businesses are in the retail sector. While there are many reasons for this decision, all small retailers share one common goal: the goal of success. To some, success is measured in terms of financial rewards, while to others, success is measured in terms of independence and a new life-style. To help ensure that their businesses are successful, retailers must practise good management.

The material for this volume is a result of numerous interviews with successful small business entrepreneurs across Canada. Many of these business people have retired, but are still directly involved in sharing their expertise with the small business community through the Federal Business Development Bank's CASE program. CASE (Counselling Assistance to Small Enterprises) is a counselling service available to both new and established small businesses.

This volume examines five important areas of retailing: planning the start, financing, pricing, inventory control, and advertising/promotion. The chapters, presented in a logical sequence and using non-technical terms, introduce you to the general concept of good retail management. Whether you are just thinking about starting a retail business of your own or are a newly established retailer, we hope that this book will be of interest to you.

The material in this book originally appeared as Pamphlets Nos. 15 to 19 in the series "Minding Your Own Business".



# 1. PLANNING THE START OF YOUR RETAIL BUSINESS

*“Why do you want to be in business? Think about that question. While you can have many reasons for going into a business of your own, your one aim is success.” — CASE counsellor*

INTRODUCTION .....	8
HOW TO GET STARTED	
i. Buy an existing retail business .....	8
ii. Start a new retail business .....	9
WHAT TO SELL AND WHY .....	11
YOUR MARKET .....	13
SELECT YOUR LOCATION .....	14
WHAT WILL IT COST? .....	16
BUSINESS REGULATIONS .....	23
SOURCES OF RETAIL INFORMATION .....	25
CHECKLIST .....	27
CONCLUSION .....	30

# INTRODUCTION

The difference between a successful retailing concern and one that fails is good management. Good management begins before you start your retail business. In other words, the start of your retail business must not just happen. It must be well planned beforehand.

It is far wiser to foresee problems and adjust for them at the planning stages than to suddenly be forced to react when your alternatives or capital may be limited.

This chapter is an introduction to various aspects of good management when planning a retail business. Use this as a guide whether you are just thinking about a retail business of your own or have already made commitments towards having a business.

## HOW TO GET STARTED

### i. Buy an existing retail business:

Buying an existing retail business provides you with a number of **advantages** that are part of the purchase package.

It's the quickest way of "being in business" by allowing you to make immediate cash sales to an established clientele. The business will have established lines of credit both with its customers and suppliers. It will also have established lines of supply for the products being sold.

If the business is large enough to have employees and they remain, this means you have staff experienced with the business. The vendor himself should be able to pass on direct experience of the business to you.

More importantly, an existing business has a proven business history which reduces the uncertainty of a retail venture. This permits you, when purchasing the business, to assess both the actual and potential of the venture. A proven business record may also make it easier for the buyer to obtain financing as the lender then is not basing the loan risk solely on forecasts that he could think are overly optimistic.

Buying an existing retail business can also bring a number of distinct **disadvantages**.

The first disadvantage is that you are “stuck” with the location of the business. The location may have originally been chosen for specific market conditions that no longer apply. The location could be in a section of town that has become rundown, or has been superseded by a new shopping centre, or serves a neighborhood no longer affluent or now less populated.

Facilities, image and business policies which are part of the purchase package can be difficult to change. Changes to the facilities can mean additional costs and also loss of revenue should the business have to close for the alterations. The image of the business is probably well established; but is it the image that you want your business to have? How many customers associate with the present image and how many would you lose by changing to a new image? Established business policies (customer credit, refunds, deliveries, etc.) may not be compatible with your “style of business” or profit plan.

You will probably be charged for goodwill (the present value of business potential that represents established customers and store reputation). Goodwill and its dollar value may be difficult to determine.

Before buying an existing business, you must make a complete analysis with a lot of questions such as:

- Why is the owner really selling?
- What is the real physical condition of the building and facilities?
- How accurate and complete are the business records?
- Are all the accounts payable recorded?
- Are there any contingent or hidden liabilities?
- What about the accounts receivable; any bad debts?
- Have you counted the inventory? Have you evaluated it and checked for slow moving items?

## **ii. Start a new retail business:**

Freedom to do what you want is the major **advantage** in starting your own business from scratch. You decide what you want to sell, how you want to sell, and where and when. You set your own “style”

of business without any restrictions of an existing set-up (existing facilities, image, policies).

Developing at your own rate is another advantage, especially if capital is limited and you must go step by step. An example of this would be the carrying of a smaller line of goods that would be expanded only as capital is built up. An existing business with an established large line of goods may put an excessive demand on your initial capital causing you to drop certain items. This can give you a business in trouble image and effect your revenues. Customers familiar with the existing line of goods and seeing them decrease may go to a competitor who carries both the dropped items and those you are still selling.

Of course there are also **disadvantages** to starting a new business instead of buying an existing one.

The first disadvantage is start-up time. This means there is going to be an outlay of money that, until you are operative, will not be offset by any revenues. Starting from scratch means that almost everything must begin (examples: layout of facilities, inventory purchase, employee hiring, market strategy, pricing strategy, establishing of supply and credit lines) before the first sale is rung up on the cash register.

The second disadvantage is that you must establish your clientele. That means your marketing strategy must work. How soon and how well it works dictates the amount of your sales; especially in the beginning when you have yet to build up your own goodwill.

The third disadvantage in starting from scratch is the higher risk and the uncertainty particularly when you are trying to prove your case for outside financing.

“Making a go of it” with a new business is, initially, strictly in the future. There is no proven past where mistakes have been made and corrected, where you know your goods will definitely sell, where you really do know that you can make money out of your venture. It’s conjecture; but based, hopefully, on a realistic forecast.

Whether purchasing an existing business or starting a new business from scratch, it is always advisable to consult both with a

qualified accountant and a business lawyer. The accountant will be in a position to assist and advise you in analyzing the business. The business lawyer can check existing titles, liens, etc. as well as advise you on all legal transactions of your business.

#### Starting a New Business

- freedom of choice location
- set your own “style” of business; no existing restrictions of image and policy
- develop at your own rate, especially when capital is limited
- slow start-up time
- initial outlay of money before operative
- higher risk and uncertainty
- financing can be more difficult

#### Buying an Existing Business

- location may be good or bad-analyze
- lines of credit and supply established with customers and suppliers; vendor and employees can pass on experience
- purchasing total business-must analyze all aspects of business; goodwill charge
- in business right away
- immediate cash sales to established clientele
- proven business history
- financing easier when based on past performance and security

## WHAT TO SELL AND WHY

The idea for most retail businesses is built around a particular product or line of products. Of course there are those who put the “being in business” idea first, and only fit in the “What will I sell” afterwards. Either way, you must give serious thought to what you are going to sell and why.

### Your retail experience

Before choosing a product or line you must be honest with yourself as to what retail experience you have. This is applicable both in a general sense and specifically to the product that you are going to sell. Many people have found out, when it is too late, that there is more to selling than just attaching a price tag.

If you are short on retail experience, then find out first all you can about it. There are many publications available that can give you an insight to retailing. Some community colleges give courses in starting and managing small businesses. In addition, you can visit and observe retail establishments. Maybe an acquaintance owns or works in a retail business and is willing to talk about it. Analyze why you frequent a particular store and not another. Are layout, courtesy, prices, number, and style of lines factors? If so, would you handle them the same way?

You may have retail experience, but is this experience directly related to the product you are going to sell? Whether in your own locality or further afield, visit shops that sell this product. Observe and ask questions.

If you do not have retail experience or retail experience in a specific line (e.g., hardware) you may wish to consider working in a shop similar to the one you are planning. A period of about six months would allow you to gain experience.

## **The product**

With the product or line itself there are a number of questions you must ask. Questions such as: Where do I get the product from and will it be available on a continuous basis? Is there a warranty if the product breaks? Do I service the product? Do I deliver? Is it a complicated and difficult product to use? Do I assemble the product myself before selling it?

The financial aspect of a product or product line must also be considered. Is it an expensive item and one that customers will hesitate before buying? Is it a cheap item that you will have to sell many of to make money? If so, can you buy it in bulk?

Is your product seasonal or just popular at certain times? If so, what are you going to sell during the rest of the year?

Is the product just a novelty? Is it a "cute gimmick," fashionable only for the moment? Maybe you can take advantage of the novelty aspect, but what happens afterwards?

Really, why have you chosen the product you are going to sell? Familiar with it? This might be good, but don't let personal preference be the overriding reason for selling a particular item. You may like fluorescent painted plastic Bavarian cuckoo clocks; but there may be few, if any, potential customers who share your enthusiasm.

A lot of questions; but, help in both determining and justifying your choice of product or product line, is included in our next topic — researching the market.

## **YOUR MARKET**

Your market research can be summed up as an estimate of demand. More simply, it can be expressed as finding out how many people want what you are going to sell.

In finding that out you will have to answer a number of questions such as: Who are these people? What are their lifestyles? What are their buying habits? Where are these people? How do I reach them?

### **Categorize your business**

The first step is to categorize your business. Maybe it's hardware, crafts, furniture, clothing, sporting goods or whatever. Then find out the size of the total market in your area for that category. Your area may be a city, a locality or a province, depending on how far afield you plan to sell.

What are the total sales for this area? Are there significant trends? Are projections available? How many businesses are there in your category sharing the sales? Answers to these questions will give you an overlook of the total market.

### **Your geographic area**

The second step is to identify and analyze the geographic area to be served by your business. Since customers usually go to the most convenient and closest place, travel distance may determine the size of your market area.

The third step is to find out all you can about the people in your geographic area. The information you should find is: present size and residents, average family size, age distribution, money available to spend, special buying attitudes, and comparison to other areas.

### **List your competitors**

In conjunction with these three steps, you should list all the competitors in your geographic area and try to assess what their "take" is in relation to the total sales. The yellow pages of your telephone directory can provide an initial listing of your competitors.

### **The analysis**

A careful analysis of all this information, obtained in steps one to three and in the list of competitors, will go a long way in enabling you to determine: (1) if there's a market for your product or product lines; (2) what you can realistically expect is your share of the market (market target); and (3) what you can forecast as your sales.

*NOTE: For sources in your market research see — SOURCES OF RETAIL INFORMATION*

## **SELECT YOUR LOCATION**

Careful study must be given to choosing the actual location of your retail business. Where you locate requires the same amount of consideration as choosing the geographic area to be served.

Too often business locations are decided upon by considerations other than the business potential. Saying a location is a "good deal" or the "price was a bargain" or "it's close to home" or "the place was ready to move in" should not be the sole factors that decide your business location.

Accessibility, visibility, and exposure to the customer usually are your most important considerations. The optimum location should combine the business potential along with your personal aims which can include the "close to home" factor. But remember that the business potential is more important.

The choices of where to locate your business are usually: downtown business district; suburban location (major and secondary shopping centres); and neighborhood location (city or suburban).

### **Downtown business district**

The advantage of you locating in the downtown business district is the immediate availability of potential customers, those working in office buildings or shopping downtown. A central location like this allows you initial exposure to a greater number of people than you could normally acquire in the same period of time through building up goodwill.

While the large number of potential customers can be an advantage in one case, this can also be a disadvantage in other cases. Most central business districts are limited in parking facilities and heavy vehicle congestion may be a deterrent to shoppers. Generally the larger retail stores are also located in the downtown business district which means stiff competition to a small business. A downtown business section, if alive, will affect you by location demand which translates into rentals and high operating costs.

Additionally, when deciding to locate in a downtown business district you must look carefully at the current phenomenon of urban decay. Is the downtown business district "still alive" after the offices close, or does everyone go home to the suburbs? Are there any shopping centres in your geographic area that are effectively drawing away shoppers, especially in the evenings and on Saturdays? Stores often changing ownership can be an indicator of urban decay.

### **Major shopping centre**

A major shopping centre offers you the benefits of a downtown business district plus accessibility and parking facilities. You also know that a major shopping centre has been established as a result of considerable market research both to the present and future (new or growing suburbs). Many shopping centres have pooled-advertising for the centre as a unit; such as special days, sidewalk sales, etc.

Limited availability of premises, high rents, and concentrated competition are some of the disadvantages to a major shopping centre.

## **Secondary shopping centre**

The secondary shopping centre has the same advantages and disadvantages as the major centre, but on a smaller scale. One benefit, in particular, that will be less is the drawing ability of the neighboring stores in the centre. Less stores will mean less people that you can count on as "walk-ins" into your shop.

## **Neighborhood location**

A neighborhood location means you are limiting your business to a specific area of people. You must be very sure that there is a market in this neighborhood for what you are selling. Light drawing power and usually poor parking facilities are disadvantages that may not be offset by low operating costs and low rentals. Most neighborhood stores, usually within walking distance of customers, are small convenience outlets.

### **When evaluating a location, consider:**

- Accessibility and convenience for customers
- Compatibility of your business with surrounding area
- Occupancy costs (including alterations)
- Visibility (Frontage) of your business and products
- Store exterior compatible with your image
- Store interior functional for your business and products

## **WHAT WILL IT COST?**

You have decided to be in business for yourself. You have analyzed your market. You know your product. You've chosen your location. Now, you must establish what this venture will cost you. Determining your financial needs is probably your most crucial exercise in planning the start-up of your retail business.

A qualified accountant can help determine your financial needs as well as plan the setting up of a practical accounting system.

**Usually, your starting costs will consist of the following items:**

### **Capital Expenditures**

- Improvements: painting and decorating, partitions, electrical, plumbing
- Fixtures: lighting, counters and shelving, sign
- Equipment: cash register, etc.

### **Opening Costs**

- lease deposit
- licences, utility and tax
- deposits
- accounting and legal fees
- accounting system and forms
- stationery and office supplies
- advertising and publicity
- insurance
- wrapping materials

### **Inventory**

- initial inventory
- reorder reserve

### **Contingencies**

- unplanned expenses always arise. Allow 10% to 20% of planned expenses

### **Reserve Fund**

- 2 to 3 months minimum of overhead costs and salaries to cover the possible lack of profitability during initial period. (Some businesses require a larger reserve, some less).

The above reflects the situation of a new business in rented premises. It does not consider the purchase of property and its related costs, nor does it reflect the goodwill charge if you had pur-

chased an existing business. Also, the equipment is shown as a purchase requiring a cash outlay; leasing has not been considered. When trying to limit your initial cash outlay, leasing — monthly payments — might be preferable to an outright purchase.

Some additional points to consider include the fact that, initially, until you have proved yourself, your suppliers may insist that all inventory purchases be on a C.O.D. or deposit basis. This will mean the requirement of ready cash. Depending on your product line, if you are starting your business in late autumn you could require a larger opening inventory in view of the proximity to the Christmas buying season.

Part of determining your financial needs (especially in the calculation of Initial Operating Costs and a Reserve Fund) should include the preparation of a forecast and a cash-flow.

## Forecast

Forecasting is the estimating of revenue, expenses and profit for a given period of time in the future. The forecast is usually prepared for the first year of operation and gives you the opportunity to assess the new business venture. Your assessment will test both the viability of a new venture as well as show up any weaknesses or shortcomings. Foreseeing problems and adjusting for them at the planning stage is far wiser than suddenly being forced to react when your alternatives or capital may be limited.

If you have purchased an existing business, the past years' records can provide meaningful data upon which to reflect any changes that you plan.

### **SIMPLY ILLUSTRATED, A FORECAST ESTIMATES THE FOLLOWING:**

Sales	\$100,000
less: Cost of Goods Sold	<u>60,000</u>
equals: Gross Margin	40,000
less: Operating Expenses	<u>30,000</u>
equals: Profit	<u><u>10,000</u></u>

Your forecast for Sales will be the result of translating your market target into a sales figure. This dollar figure will be based primarily on competition oriented pricing. In other words, the selling price of your product would normally be set by what your competitors are charging for the same or similar product.

Your pricing strategy should also include such concepts as cost plus mark-up, market demand, competitors' prices, psychological pricing, and units to break even.

If your product is a high priced item, you can determine your Sales figure by multiplying the number of items you estimate to sell by the selling price. If you are going to carry a large number of products, with a low price, your Sales figure will be determined on a volume basis. In all cases, you may have to determine your Sales based on a percentage estimate of your share of the market.

Forecasting Cost of Goods Sold is the determining of the cost of the products that you will sell during a given period of time (in direct relationship to your forecasted sales). Again, if your product is a high priced item, multiplying the costs of the product by the number of items to be sold will give you your Cost of Goods Sold.

For low priced items, the calculation is usually as follows:

Beginning Inventory (1st day of period)	\$ 4,000
plus: Purchases (during the period)	<u>7,000</u>
equals: Goods Available for Sale	11,000
less: Ending Inventory (last day of period)	<u>5,000</u>
equals: Cost of Goods Sold	<u><u>6,000</u></u>

The answer, Cost of Goods Sold, subtracted from your Sales, will give you Gross Margin.

To forecast Operating Expenses, you will identify your selling, administrative and general expenses; e.g., those expenses that are incurred in the daily running of your retail business. (Depreciation of fixed assets such as fixtures and equipment is an Operating Expense; but the purchase cost of these fixed assets is not.) Subtracting your Operating Expenses from Gross Margin will give you the estimated Profit for your business.

Ideally, your forecast would not only be done for a year, but also on a quarterly or monthly basis. This can be advantageous in seeing where your “lean” periods may occur.

## **Cash flow**

Cash flow (sometimes known as cash forecast or cash budget) if done realistically, will show you, on a month to month basis, what cash you estimate to receive, what cash you will have to pay out and where you may have cash surpluses or shortages. It is advisable to have qualified assistance in the preparation of your cash flow.

If you give credit to your customers you will have to reflect in your forecast when your accounts receivable will generate cash in. Sales paid by most credit cards are treated as immediate cash from sales.

## ILLUSTRATED SIMPLY, IS A CASH FLOW FOR A BUSINESS'S FIRST THREE MONTHS OF PROPOSED OPERATIONS.

The following assumptions have been made:

- a) Sales are \$6,000 in the first month, \$8,000 in the second month, and \$8,000 in the third month;
- b) Cost of Goods Sold is 67% of Sales;
- c) Approximately  $\frac{1}{3}$  of Sales are on credit. Terms are net 30 on Sales;
- d) A \$9,000 term loan has been obtained from a financial institution to purchase fixed assets;
- e) The owners have invested \$10,000 into the business;
- f) Inventory purchases are on a 30 day credit.

	1 <sup>st</sup> month \$	2 <sup>nd</sup> month \$	3 <sup>rd</sup> month \$
<b>Add Cash Receipts:</b>			
Term Loan Proceeds	9,000	—	—
Owners' Share Capital	10,000	—	—
Cash from Sales	4,000	5,000	5,000
Cash from Receivables	—	2,000	3,000
<b>Total Receipts</b>	<u>23,000</u>	<u>7,000</u>	<u>8,000</u>
<b>Less Disbursements:</b>			
Improvements	4,000	—	—
Fixtures	5,000	—	—
Equipment	2,500	—	—
Inventory	4,000	5,000	5,000
Rent (incl. deposit)	1,500	500	500
Heat, Light & Power	300	300	300
Wages & Taxes	850	1,000	1,000
Advertising	300	200	250
Office Expenses	300	200	200
Insurance	500	—	—
Term Loan Repayment	—	300	300
<b>Total Disbursements</b>	<u>19,250</u>	<u>7,500</u>	<u>7,550</u>
<b>Cash Surplus (Shortage)</b>	<u>3,750</u>	<u>(500)</u>	<u>450</u>
<b>Cash on Hand:</b>			
Beginning of Month	—	3,750	3,250
End of Month	3,750	3,250	3,700

## Sources of capital

After determining your financial needs, the next step is to find the money. The sources of capital needed to start a retail business generally are as follows:

- Personal savings
- Loans from family or friends
- Partner's investment or share-capital (if incorporated)
- Loans from financial institutions
- Trade credit from your suppliers
- Loan from owner if you buy an existing business.

## Planning and presentation

The financing of your project must be well planned. For once you have committed yourself to your new business, an unexpected, and unprovided, requirement for cash can mean cutbacks or possible disaster. Before you start in business, you must know what your financial limitations are and set realistic goals. For when you are in business, you do not want to suddenly face a reality that bears little resemblance to your optimism.

When you are going to other people for capital or for credit, a good presentation (summary of starting capital needs, forecast, cash flow) based on realistic research goes a long way towards demonstrating the viability of your venture. A good presentation and a realistic research prove also to you that your venture is viable.

In conjunction with this part, What will it Cost?, you are referred to volume I of "Minding Your Own Business".

- chapter 5 Forecasting for an existing business
- chapter 6 Forecasting for a new business
- chapter 3 Working Capital
- chapter 8 Presenting your case for a term loan
- chapter 2 Managing your cash

## **BUSINESS REGULATIONS**

This section, unlike the others in this chapter, is not an introduction; but instead, is a warning.

As a business operator you will be faced with certain legal obligations to municipal, provincial and federal governments. The regulations are many and varied; all dependent on your type of business, the product, and your location.

You are strongly advised to make sure that you know all the regulations that will be applicable to your business in your particular city/town and province prior to actually starting your business.

Your lawyer and accountant will be in a position to advise you on these regulations. Chambers of Commerce, local business associations and fellow businessmen can, in general terms, indicate to you what regulations are applicable.

The following indicate the type of regulations affecting the retailer from three levels of government:

### **Municipal**

- City Business Permit
- Zoning By-laws (opening hours and location)
- Land Use Regulations
- Business Taxes
- Property Taxes
- School Taxes
- Water Taxes
- Building Permits (applicable to alterations also)
- Building Codes (plumbing, electrical, fire and health hazards)

### **Provincial**

- Business Registration (proprietorship under another name and partnership)
- Bulk Sales
- Incorporation (provincial charter)
- Land Use Regulations (certain provinces)
- Provincial Business Licence

- Provincial Corporation Income Tax
- Quebec Place of Business Tax (Quebec only)
- Provincial Sales Tax
- Provincial Building Codes (electrical apparatus and equipment, fire and health hazards)
- Minimum Age for Employment
- Minimum Wage for Employment
- Hours of Employment
- Annual Vacations and Public Holidays
- Workmen's Compensation
- Quebec Pension Plan (Quebec only)
- Safety and Health
- Provincial Health Insurance
- Maternity Leave
- Termination of Employment
- Payroll Tax Deductions (monthly remittances to government)

## **Federal**

- Incorporation (federal charter)
- Federal Corporation Income Tax
- Federal Sales Tax
- Export/Import Permit
- Customs Duties
- Building Codes
- Industrial Health and Safety
- Unemployment Insurance
- Canada Pension Plan (except Quebec)
- Payroll Tax Deductions (monthly remittances to government)
- Trademarks
- Copyrights
- Industrial Designs
- Patents
- Product Safety
- Combines Investigation (includes false advertising)

To get an idea of how these regulations really do affect the retail business, see — CHECKLIST

## SOURCES OF RETAIL INFORMATION

The section which introduced market research gave you a lot of “find outs”. But where do you find out the statistics and information that you need?

**Your own knowledge of the area** and that of others is your initial source. If you are locating your business in an area that you are familiar with, you will be able to draw upon your own knowledge and that of people you know. Even if you are a newcomer to a specific area, just talking to people (shopkeepers, neighbors, etc.) with the idea of finding out certain information can bring results.

**Visiting shops** similar to the one you are planning may allow you to learn the up-to-date situation of that type of business. This can be especially true when visiting a shop in a non-competitive location to your planned shop where the owner or manager may be willing to talk openly about the business to you.

**Chambers of Commerce and local business associations** are also prime sources of information. Most areas have service clubs (Kiwanis, Lions, Rotary, etc.) that have large memberships of business people that can provide valuable contacts.

**Statistics Canada**, Canada's central statistical agency, is your prime source for compiled information. Statistics collected, from government, business, and individuals, range from national aggregates to small area data covering only a few blocks of a single municipality, and from broad economic studies to specific matters. Data is published monthly, quarterly and annually, depending on the topic. Statistics Canada, as well as advising you of what information is available and how it might best be utilized, can also give you data actually keyed to your specific needs.

**Government Departments**, both Federal and Provincial, are valuable sources of information. A number of these include the Federal and Provincial Departments of Industry, Trade and Commerce; the Technical Information Service (TIS) of the National Research Council; the Department of Regional Economic Expansion (DREE); and the Provincial Development Corporations. Many government departments have information divisions available to you (e.g.,

Canada Post has data available as detailed as giving names, mailing addresses, occupations and language preference — French/English — of householders served through post offices).

**By contacting the Federal Business Development Bank (FBDB),** you can find out what government information services are available to meet your needs. Books and pamphlets on retailing are available at each of the FBDB's branches. The FBDB also provides a counselling service (CASE: Counselling Assistance to Small Enterprises) that can assist you in planning your business.

**Your municipal government (City Hall)** is another source not to be overlooked. Information on by-laws, zones, development plans, etc., as well as statistics; all applicable to the municipality, are available for your research.

**Advertising agencies and direct mail firms,** can, at a fee, supply you with market data and survey information.

**Libraries** can also be a source of retail information or put you in contact, via inter-library loans, with libraries specializing in economics, business, banking, etc.

**Trade associations, retail associations** and their publications can provide you with assistance and information. Membership usually is a requirement. Your library or Chamber of Commerce should be able to direct you to the nearest contact.

**Suppliers** can be a good source of general sales data and of merchandising information in your area. Because the sales representatives of the supplier probably serve other businesses and your competitors, you can obtain valuable information on the "current scene".

There are other sources of retail information beyond what we have listed. But remember, information will not come to you, you must look for it. Asking questions of people is the easiest way of getting information.

# CHECKLIST

This section consists of a checklist for you to complete. Some of the questions have been examined earlier; while other questions are there as an inducement for you to enquire further into the aspects of opening your own retail business.

## QUESTIONS

	YES	NO
<b>Buy an existing business:</b>		
Have you analyzed the business?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the advantages?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the disadvantages?	<input type="checkbox"/>	<input type="checkbox"/>
Why is the business being sold? Do you know the <b>real</b> reason?	<input type="checkbox"/>	<input type="checkbox"/>
Have you examined the accounting records?	<input type="checkbox"/>	<input type="checkbox"/>
Have you had the accounting records checked by an accountant?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked the accounts payable?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked the accounts receivable?	<input type="checkbox"/>	<input type="checkbox"/>
Are you buying the inventory and, if so, is it at a fair price?	<input type="checkbox"/>	<input type="checkbox"/>
Is there a charge for the goodwill and, if so, is it a fair charge?	<input type="checkbox"/>	<input type="checkbox"/>
Is the price for the business fair?	<input type="checkbox"/>	<input type="checkbox"/>
Is the business what you really want?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Start a new business:</b>		
Are you aware of the advantages?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the disadvantages?	<input type="checkbox"/>	<input type="checkbox"/>
<b>What to sell and why:</b>		
Do you have retail experience?	<input type="checkbox"/>	<input type="checkbox"/>
If not, have you learnt about it?	<input type="checkbox"/>	<input type="checkbox"/>
Have you decided what products to sell?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you know why you want to sell a particular product?	<input type="checkbox"/>	<input type="checkbox"/>
Can you get the products easily and continually?	<input type="checkbox"/>	<input type="checkbox"/>
Have you examined the product as to how well it can sell?	<input type="checkbox"/>	<input type="checkbox"/>

### Your Market:

Have you researched the market?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what the total market is?	<input type="checkbox"/>	<input type="checkbox"/>
Have you chosen your geographic area?	<input type="checkbox"/>	<input type="checkbox"/>
Have you analyzed your geographic area?	<input type="checkbox"/>	<input type="checkbox"/>
Have you listed your competitors?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know your competitors' share of the market?	<input type="checkbox"/>	<input type="checkbox"/>
Have you determined your share of the market?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know why customers will buy from you?	<input type="checkbox"/>	<input type="checkbox"/>
Have you made a plan to attract customers?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how you will counter competition?	<input type="checkbox"/>	<input type="checkbox"/>

### Location:

Have you analyzed your business location as to business potential?	<input type="checkbox"/>	<input type="checkbox"/>
Is there good customer accessibility to your location?	<input type="checkbox"/>	<input type="checkbox"/>
Is your location easily visible?	<input type="checkbox"/>	<input type="checkbox"/>
Will you have good exposure to customers?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the advantages of locating in a downtown business district?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the disadvantages of locating in a downtown business district?	<input type="checkbox"/>	<input type="checkbox"/>
If locating downtown, is there urban decay?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the advantages of locating in a major shopping centre?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the disadvantages of locating in a major shopping centre?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the advantages of a secondary shopping centre?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the disadvantages of a secondary shopping centre?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you know what type of business is usually found as a neighborhood store?	<input type="checkbox"/>	<input type="checkbox"/>
Is your business compatible to the surrounding area of your location?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know your occupancy costs?	<input type="checkbox"/>	<input type="checkbox"/>
Is the store interior functionable for your business and products?	<input type="checkbox"/>	<input type="checkbox"/>
Will you have to make alterations?	<input type="checkbox"/>	<input type="checkbox"/>
Is the store exterior compatible with your image?	<input type="checkbox"/>	<input type="checkbox"/>

### Finances:

Have you forecasted your sales realistically?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked your competitors' prices?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have the costs of what you are going to sell?	<input type="checkbox"/>	<input type="checkbox"/>
Have you estimated your operating expenses?	<input type="checkbox"/>	<input type="checkbox"/>
Have you done a cash flow?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what your start-up costs will be?	<input type="checkbox"/>	<input type="checkbox"/>
Have you allowed for unplanned expenses?	<input type="checkbox"/>	<input type="checkbox"/>
Are you going to set aside a reserve fund for initial operating costs?	<input type="checkbox"/>	<input type="checkbox"/>
Will your initial inventory purchases be on C.O.D.?	<input type="checkbox"/>	<input type="checkbox"/>
Have you examined the possibility of leasing equipment instead of buying?	<input type="checkbox"/>	<input type="checkbox"/>
Have you made an outline of your financial requirements?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the sources for capital?	<input type="checkbox"/>	<input type="checkbox"/>

### Business regulations:

Have you checked with a lawyer as to applicable regulations?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked the municipal zoning by-laws?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have a business permit?	<input type="checkbox"/>	<input type="checkbox"/>
If buying a business's inventory or an interest in a business, have you obtained an affidavit from the seller listing the names and addresses of the business's creditors and the amounts owed to them? (Bulk Sales Regulations)	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you know the business, property, school and water tax rates for your business?	<input type="checkbox"/>	<input type="checkbox"/>
Does your building comply with government standards?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of minimum wages and labour regulations?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the risk of false or misinterpreted advertising?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know about product standards?	<input type="checkbox"/>	<input type="checkbox"/>
As you purchase goods for resale, have you a provincial sales tax exemption permit?	<input type="checkbox"/>	<input type="checkbox"/>
Have you obtained a certificate from your provincial government to collect provincial sales tax on their behalf?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know that income taxes, deducted from employees' salaries, must be remitted each month to the federal and provincial governments?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the federal and provincial rates for your business?	<input type="checkbox"/>	<input type="checkbox"/>

### **Other Requirements:**

Do you know what insurance policies (fire, theft, accident, etc.) your business will need?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what your insurance policies will cost?	<input type="checkbox"/>	<input type="checkbox"/>

## **CONCLUSION**

It is better to find out, before you are in business, the answers to those key questions: Can I manage a retail business? Can I afford to be in business? How much will the business cost me? Can I demonstrate that the business will have a good chance of being successful?

This chapter is a guide; an introduction to good management in planning the start of a retail business. What you do with the advice and how you apply it to the planning of your own retail

business could be the difference between a successful concern and one that is in trouble.

Once you have carefully drawn up your plan, follow it through; yet be flexible to take advantage of opportunities and to avoid pitfalls.



## 2. FINANCING FOR YOUR RETAIL BUSINESS

*“Good management is the key to success in your retail business and is the major assurance to a lender or investor that money put into your business is safe.” — CASE counsellor*

INTRODUCTION .....	34
WHAT IS RETAIL FINANCING? .....	34
WHY DO RETAILERS HAVE PROBLEMS OBTAINING FINANCING? .....	35
WHAT ABOUT THE PROBLEMS OF LACK OF EQUITY AND DEBT LOAD? .....	37
WHAT SECURITY CAN A RETAILER PROVIDE? .....	38
WHAT KIND OF FINANCING IS AVAILABLE TO A RETAILER? OWNERSHIP DOLLARS .....	40
BORROWED DOLLARS .....	42
SOME TYPES OF SHORT AND INTERMEDIATE-TERM FINANCING .....	43
WHAT IS THE DIFFERENCE BETWEEN TERM LOAN AND DEMAND LOAN? .....	47
WHAT DETERMINES INTEREST RATE AND RISK? .....	47
CAN A RETAILER GENERATE FUNDS FROM WITHIN THE BUSINESS? .....	48
HOW DOES A RETAILER ESTABLISH A CREDIT RATING? ....	49
WHAT PAPERWORK DOES A RETAILER NEED WHEN SEEKING FINANCING? AND WHY? .....	50
WHAT IS THE PROCEDURE IN APPLYING FOR RETAIL FINANCING? .....	55
CONCLUSION .....	56

## INTRODUCTION

Knowing the "what's involved" can give a retailer a decided advantage in securing financing. When you are looking for financing, you must remember that you are in competition with other businesses for the same money. Lenders and investors look for evidence of good management from an applicant. Being prepared, knowing the procedures, and being aware of the various kinds of financing available to retailers are your first steps in demonstrating good management in your financing proposal.

This chapter is an introduction to retail financing. It looks at the problems of financing a retail operation, security in retail financing, and the kinds of financing available to retailers. As well, it examines the paperwork you will need when applying for financing from a lender or investor and the procedures involved in your application.

## WHAT IS RETAIL FINANCING?

Retail financing can be simply defined as a combination of:

- (1) the need for money by a retailer,
- (2) the provision of money to a retailer by a lender or investor.

The need for money can be when your retail business is getting started, when you are doing well and wish to expand, and it can be in lean times to ensure survival. Retail financing therefore is a factor both when business is "booming" and when you are striving to hold off the "bust".

The provision of money can be divided into two categories: ownership money and borrowed money. Ownership money is equity financing and the use of a business's profits. Borrowed money is loans and trade credit. The borrowed money category is the most common form of retail financing. It is in this category that the words, "risk" and "interest", become important.

Before examining the kinds of financing available to retailers, we should see how lenders view a loan proposal. As borrowing money will be your usual recourse for financing, it is advisable to

know why retailers can sometimes run into difficulties obtaining their financing.

## **WHY DO RETAILERS HAVE PROBLEMS OBTAINING FINANCING?**

The major reason why a great number of retailers have their loan proposals reduced or, at worst, turned down is because of limited security.

Imagine, instead of being a retailer, you are a lender and are faced with the following situation:

Jim and Betty Nickle, who have been residents in your town for the past fifteen years, are planning to lease premises on Main Street. Their new store will be called 'Nickle Shoe Shop'.

"You see," says Jim, "I've spent ten years as a salesman for a shoe wholesaler. So I'm a natural to open a retail shoe store. Plus think of my contacts."

"Well," you say cautiously, "that certainly seems to be an advantage. Let's look at your application. You want to borrow \$30,000?"

"That's right. It's to cover my start-up costs. I have to paint the place and put down a carpet. I need counters, display racks and shelving. They will all be custom made. I need a cash register, a neon sign with 'Nickle Shoe Shop' on it, and I want to enlarge that front window. Plus I must pay three months' rent in advance. \$20,000 of my loan will be for inventory. My suppliers will give me credit once I've established myself."

"I see," you reply and turning to Betty Nickle ask, "What about yourself, Betty? Will you keep your present accounting job at the cannery?"

"No, I'm not. Jim and I are enthusiastic about our venture. Both of us are going to work full time in the store. We're not afraid of hard work and we feel that our hard work now will pay

off in the future. I'll be looking after the cash register and doing the clerical work. I'll also help Jim with the customers. That way we don't have to pay a salary to an outsider."

"That's one way of looking at it," you answer and, referring to the loan application, "The amount of your investment in 'Nickle Shoe Shop' will be \$8,000, right?"

"That's the amount," agrees Jim, "It'll cover our working capital needs and we'll use it to pay the monthly loan payments."

Why are you, the lender, hesitant about loaning \$30,000 to Jim and Betty Nickle? Why is the loan proposal questionable?

Jim and Betty are enthusiastic. They say they are going to work hard. Jim knows the shoe business and he has supplier contacts. Both Jim and Betty are longtime residents in the town. Betty knows bookkeeping from her job at the cannery. The store will be located right on Main Street and the town does need a local shoe merchant. Jim and Betty are investing \$8,000. So what is wrong?

There are a number of problems with Jim and Betty's loan application. The problems fall into three categories: security, lack of equity, and debt load.

The first problem is security. If 'Nickle Shoe Shop' fails, how much of your \$30,000 will you get back? Like the vast majority of retailers, Jim and Betty's operations will be in leased premises. Leasehold improvements such as painting, alterations, and partitions are not retrievable by the lender. Lighting fixtures, counters, shelving, and sign are usually custom made and, if they can be removed, have limited resale value. Rent paid in advance is also unretrievable as most retail leases are commitments for one year. It must be remembered that the lessor has one of the first calls on a business's assets, both by virtue of the law and by virtue of the business being on his premises.

Inventory is also a problem of security. You, as a lender, have little control over the inventory. You may be the last to know if it is still on the premises. If a business fails because it couldn't sell its inventory, what better chance has the lender to sell it, even at cost?

In financing a retail business, lenders want to be sure they won't lose their money. Therefore, the security for a retail loan is appraised by three different methods.

The most optimistic method is **Going Concern Value** which is an estimate of the business based on its capitalized earnings. This assumes that a selling price, sufficient to cover the loan, will be obtained if the business is sold as an ongoing concern. Of course this gives no indication of the value of the assets if the business is not sold in this manner.

**En Bloc Value** is an estimate of the price at which the assets could be sold, without alteration or removal, if the business has ceased to operate. The estimated value is only meaningful if one could assume that a prospective buyer will value the business in relation to how much it would cost him to reproduce a similar operation.

The third method by which lenders appraise security is **Current Liquidation Value**. This is the estimate of what price the assets might be expected to realize on a forced sale or on the winding up of the business. This is based on the assets being sold individually. The majority of lenders realistically use Current Liquidation Value in appraising the security for a loan.

Assets usually are the security for a loan. 'Nickle Shoe Shop' will be like the majority of retail operations: limited assets available as security. This, therefore, is the major reason why many retailers generally have difficulty obtaining their financing.

## WHAT ABOUT THE PROBLEMS OF LACK OF EQUITY AND DEBT LOAD?

In the case of Jim and Betty Nickle, their \$8,000 is a lot of money to them and represents their savings. While few lenders, if any, will state a ratio of equity to borrowings, there must be a sufficient investment in the business by the principals of the business to ensure their continuing commitment.

What happens if they get their \$30,000 loan and find that in the first few months they can't cover their commitments, or, if initially

successful, they run into a slump for a couple of months? Will their \$8,000 be sufficient? If not and if \$8,000 is all they have as an investment — it could mean failure. A second loan at this stage may be impossible to find.

Debt load is the second problem area. A \$30,000 loan of this nature might have a term of three to four years. This means payments of approximately \$1,000 a month. 'Nickle Shoe Shop' will have to meet these monthly loan payments as well as the regular commitments of operating expenses (rent, heat, light, advertising, insurance, telephone, etc.), continuing inventory purchases, and a salary for Jim and Betty to cover their living expenses. Will their sales be sufficient?

Debt load and equity are factors which lenders consider when evaluating a business as a viable concern. Security is what lenders use to protect their loan in case they have misjudged and the business fails.

These last two sections of the chapter may appear to be very discouraging. But when you are seeking retail financing it is to your advantage to look at your request from the viewpoint of a lender.

## **WHAT SECURITY CAN A RETAILER PROVIDE?**

In a previous section of this chapter, you have seen that the major stumbling block in retail financing is security. Yet retailers do get loans; so what security does a retailer have that can be used to assist in securing financing?

**The average retailer will usually be able to determine security from amongst the following:**

- fixed assets
- assets separate to the business
- income separate to the business
- inventory
- accounts receivable
- customers' orders
- the business as a "going concern"

**Fixed assets**, by definition, are tangible long-lived items and are your land, buildings, and equipment. If you own the building and land where your business is operating, you are then in a strong position by giving a realty mortgage as security. The strength of this security will, of course, vary by the amount of unpaid mortgage and the market value of the property. Most retailers, however, are in rented premises, especially those in shopping centres and downtown business districts. So therefore their fixed assets are only equipment such as a cash register, adding machines, or a delivery truck. These have limited value as security.

**Assets separate to the business** can be your house, other properties, bonds, stocks, or your life insurance policy if it has a cash or paid-up value. In applying for a loan, the security of a saleable personal asset can satisfy the security aspect of a new retail business. The disadvantage to this arrangement is the linking of your non-business assets to the risk factor of your retail business.

**Income separate to the business** is sometimes an assurance to lenders that a loan will be repaid or that there is recourse to protect the loan. In cases such as this, the loan to the business would be treated as a personal loan and the amount of the loan would be in relation to the income. Income separate to the business would be where one or more of the business's owners has kept an outside job or has investment income. Again you are linking your non-business life to that of your retail business.

It should be stressed that lenders would only accept a situation like this for a short period of time. Twelve months at the most for, by then, a retail business usually indicates if it is a viable enterprise or not. A business should be able to support itself as justification for a loan, not depend on income separate to the business.

**Inventory** which often is the purpose of retail financing is, to certain lenders, security. The dollar worth of the inventory, the type (is it made up of "large ticket" items such as autos and refrigerators) and the turnover rate (how fast will it sell), are what determines the value of the inventory as security. When the retailer takes possession of inventory, ownership comes with it. Again it must be pointed out that because lenders can have little control over the inventory and the fact that most retailers do not deal in "large ticket" items that justify flooring, inventory is not normally retail security.

**Accounts receivable**, in most retail establishments, have been replaced by customers' credit cards. Usually only the large retailers that are suppliers on a major scale to other businesses or institutions carry receivables. The amounts and past due status of the receivables determine their value for security. Accounts receivable when the scale warrants, are used by retailers in factoring.

**Customers' orders**, if contractual and of a substantial volume and value, can be used as security. An example of a retailer in this situation is one who purchases disposable paper products from a manufacturer and has sales contracts with a number of restaurants. The sales contracts would be the security for purchasing the inventory. Generally, lenders would view this as short term. Customers' orders should really be considered as a facet of the business as a going concern.

**The business as a going concern** is when a retail business has proved itself as a viable and successful enterprise over a period of time and is reasonably expected to continue being successful. The security for lenders is the proven good management, the past earnings, and the future potential. Going concern status is a basis for lenders extending a line of credit.

## WHAT KIND OF FINANCING IS AVAILABLE TO A RETAILER?

Your two kinds of retail financing are: ownership dollars and borrowed dollars. Let us examine both kinds, beginning with the four categories in ownership dollars (three of equity financing and one of profits).

### Ownership Dollars:

**Sole ownership** is your first category of equity financing. The source of your financing can be your personal savings, securities, other assets, real estate, as well as borrowings from your relations and friends.

This is one of your most important sources of retail financing. The more of your own money that you put into your business will

mean the less you will have to borrow and the less loan interest you will have to pay. If and when you do go to a lender, a good investment of your own will give the lender confidence in your business commitment.

It must be stressed that in a sole ownership you own all the assets and are responsible for all liabilities. All decisions concerning the business are yours alone. Therefore, when borrowing money from relatives and friends, it is advisable to have a written agreement setting out terms and conditions for having borrowed the money as well as what management advice, if any, these people will give you in operating your business.

**Partnership** is the second category of equity financing. It may be that you cannot come up with sufficient financing from your own sources as listed under sole ownership. You may not wish to or cannot go to a lender. Equity financing, in the form of one or more partners, can be a source for your retail business.

Your partner or partners will put up money and agree to share with you the ownership of the business and the resulting profits and losses. You will have to determine with your partners what their share of the business will be based on considerations both of amounts of money invested and their share in the management decisions. They may be silent partners, providers of money while you provide the know-how, or they could be working partners supplying both money and skills to the business. Partners are referred to as either general or limited. A general partner is active in management and is responsible for all debts and obligations of the partnership. A limited partner only contributes money and is not responsible for the business's debts and obligations.

**Limited company** is the third category of equity financing. This means that you incorporate your retail business and sell shares of the company to a number of specified people. Your business is a legal entity, separate from yourself and the other persons (all of you are shareholders) who own it. Your business can own assets, make contracts and conduct business transactions in its own capacity.

The majority of incorporated small retail businesses are private companies. As a private company, there can be legal restrictions as to the number of shareholders and the transfer of shares. The amount

of the shares and the value and rights are determined at the time of sale. The percentage of the shares (who has how many) dictates controlling interest of the business. If an incorporated business fails, each shareholder (owner) is liable for all shares he or she has purchased but not paid for. The shareholder is also responsible for any loans personally guaranteed for the business.

**There are two good reasons to consider outside investors in your retail business:**

These outside equity monies do not normally have to be repaid (on a regular basis) and are therefore not a drain on your business's cash flow.

Your outside investors have a vested interest in your business and you can look to them for continuing support.

It is better to own a large percentage of a profitable business than one hundred percent of a business that fails.

**Profits** is the last category in ownership dollars and is the most ideal source of retail financing for an existing business. This is where you retain a portion of the profits from the business for reinvestment. This supplements or replaces going to a lender or to outside investors when you need financing.

### **Borrowed Dollars:**

Borrowed dollars, sometimes called debt financing, will be your most common kind of retail financing. Borrowed dollars are usually identified by their terms of repayment time: short-term, intermediate-term, and long-term.

**Short-term financing** is generally considered to be financing extended to a business for one year or less. Retail businesses usually seek short-term loans for working capital purposes such as operating expenses, seasonal slack periods, and inventory build-up for sales. Short-term loans may also be used for an interim period while arranging longer term financing.

Short-term financing is easier to obtain than intermediate-term and long-term. Usually it is less expensive than the longer term financing. The security for short-term financing is normally the business valued as a going concern, though other security may be requested. Short-term financing is generally on a revolving basis, renewed regularly, though it can often be withdrawn on short notice. Short-term financing is expected to be paid from the business's ordinary operating income once the temporary need is over.

**Intermediate-term financing** is used by retailers for periods of approximately one year to five years. Intermediate-term financing provides monies for other than temporary needs. The purposes can be: purchasing of an existing business, establishment of a new one, additional working capital for expanded business operations, purchase of assets, or for leasehold improvements.

When arranging for this term of financing, it is important to specify the duration of the loan as well as to establish in detail its terms and conditions. Be aware of such facets as interest rate, front end charges, security requirements, term and payment flexibility and also the possible requirement for periodic financial statements. Because of the years involved and the commitment you are tying your business down to, you must be sure that the terms and conditions are compatible with the short and long-range plans of your business. These loans usually require security.

**Long-term financing** is financing for a period exceeding five years. This category of borrowed dollars can be the most difficult for a retailer to obtain, unless the purpose of the loan is for a high value asset such as a building or land. Long-term financing, which requires the same attention as intermediate-term, usually is met by equity financing or equity financing combined with intermediate-term financing. Often a retail business's long-term financial needs should be met by more equity investment rather than by a loan.

## **SOME TYPES OF SHORT AND INTERMEDIATE TERM FINANCING**

Short and intermediate-term financing are also referred to by other names than just by length of time. Briefly described are a

number of common types of short and intermediate-term financing that can be available to retailers. In reading this section, you should not assume that all of these types of financing are available to your retail business.

**Trade credit** is the most often used form of short-term financing by retailers. This means a supplier will not insist on immediate payment by a retailer for purchase of merchandise. Terms can be arranged between both parties as to when payment will be made: 30 days, 60 days or longer. This allows the retailer to obtain inventory without an immediate cash outlay and to begin selling it right away.

Most suppliers have terms of net 30 days and will charge a retailer interest after the due date for any accounts past due. Not having to immediately pay for inventory allows a retailer to use his or her working capital for other aspects of the operation. It also gives the retailer time to generate sales to pay for the inventory. This arrangement between retailer and supplier usually only occurs with an established business.

**Line of credit** is an agreement between a business and its bank. The bank agrees to grant loans as requested as long as they do not exceed a determined and agreed upon maximum. The retailer will sign notes of specific amounts and present them to the bank to cover loan needs. The notes are returned by the bank as the retailer repays. These loans are at times unsecured and are based on the business as a proven viable operation. Retailers who have seasonal needs for funds because of their product will use a line of credit with their bank.

**Temporary financing**, unlike a line of credit, is a short-term loan for a specific period of time ranging from 30 to 90 days. Its purpose is generally for seasonal financing or for a build-up in inventory. While this type of loan is often unsecured and based on the business as a proven viable enterprise, security can at times be requested. The loan may also be on demand, meaning it can be called at any time for payment.

**Factoring** is an expression used where a retailer sells his or her accounts receivable to a factoring company. The retailer gets immediate cash for these receivables. The factor who now has the responsibility and risk of collecting the receivables, will levy a per-

centage service charge on the face amount of the receivables. The retailer is also charged interest for the period between the time of obtaining the money and the maturity date of the receivables.

The amount of the receivables, the age of the receivables and, above all, the credit rating of the retailer's accounts receivable customers, will dictate what receivables a factor will buy. Factoring, while giving immediate cash, is a more expensive way of raising money when compared to others forms of retail financing.

**Assignment of accounts receivable** differs from factoring in that the retailer retains control of the receivables. The receivables are assigned to a bank or other lender as security for a short-term loan. The lender will loan a certain percentage of the face value of the receivables and charge the retailer interest and possibly a service fee. When requiring funds, the retailer prepares a schedule of assigned receivables and signs a note to the lender. When the receivables are collected the retailer pays the lender and retrieves the note. The soundness of the receivables, as in factoring, dictates their value for this type of retail financing. Assignment of accounts receivable is often the rotating security taken for a line of credit when security is requested.

**Flooring** is used by retailers selling "large ticket" items such as automobiles and appliances that can be easily identified and have a high unit value. In this situation, the lender pays the manufacturer the cost price of the inventory and retains the ownership. The retailer has possession and sells the units. As each unit is sold, the retailer pays the lender the amount due on the unit. The retailer signs a note in this type of financing and pays an interest charge for the time taken to sell the unit and pay the lender.

**Chattel mortgage loan**, for a retailer, would be a short or intermediate-term loan which is secured by the movable assets (chattels) of the business and sometimes, if necessary, the movable assets belonging personally to the owners of the business. The security is discharged (released) to the retailer upon the payment of the loan. The current liquidation value of the chattels can qualify the amount of the loan.

Note: In the province of Quebec, "Commercial Pledge" is the equivalent security used for chattel mortgage. Commercial

pledge loans can only be granted to the business contracting the loan on assets owned by it.

**Floating charge debenture loan**, again in a short or intermediate-term situation, is a loan secured by a general claim on the total equity of the business. Unlike a chattel mortgage and a commercial pledge which specify and describe a particular asset as security, a floating charge debenture does not describe any specific assets. Instead, all the assets are described in general terms and could be disposed of in the ordinary course of business until default occurs.

The lender may include certain restrictions and controls on the business so as to ensure that the equity of the business does not fall below that deemed necessary to secure the loan. In certain provinces, companies must be incorporated to obtain this form of financing. A business with a floating charge debenture as security may still obtain other short-term credit by charging (e.g., chattel mortgage) specifically the assets of the business. The holder of the floating charge debenture ranks after the claims of lenders holding specific securities such as chattel mortgages.

Note: In the province of Quebec, "Trust Deed" is the equivalent security used for floating charge debenture.

**Installment purchase plan** can be used by retailers to purchase chattels (e.g., equipment, vehicles, furniture). They obtain possession and title but, instead of paying for the purchase immediately, agree to pay in installments over a specified period of time. Each installment will usually have built into it repayment of principal, plus interest and service charge. In the majority of cases, conditional sales contracts are used instead of installment purchase plans.

**Conditional sales contract** differs from the installment purchase plan in so far as the retailer has possession of the purchased chattel but not the title. Payments are made by the retailer over a specified period of time. Each payment includes repayment of principal, plus interest and service charge. Upon the last payment, the retailer becomes the owner of the purchased chattel.

**Equipment leasing** is the use of equipment or other movables for an agreed period of time and rental. Certain leasing arrangements enable the lessee to apply the payments against the purchase price,

or pay a residual value at the end of the lease period and take title of the equipment.

## WHAT IS THE DIFFERENCE BETWEEN TERM LOAN AND DEMAND LOAN?

It is important for a prospective retail borrower to be aware of the difference between the words “term” and “demand”. As shown earlier, you should not judge loans solely on interest rates but must examine all their aspects. Knowing the advantages and disadvantages of both types can help you choose the best one for your business.

### Demand loan

- interest rate at time of signing usually lower than term
- fluctuating interest rate — rates go up, you pay more
- often unsecured — based on proven business record
- loan can be called any time by the lender and payment demanded
- quicker to obtain

### Term loan

- interest rate at time of signing slightly higher than demand
- normally fixed interest rate — your payments stay the same
- usually secured by fixed assets
- time length of loan specified and agreed upon
- takes time to obtain

## WHAT DETERMINES INTEREST RATE AND RISK?

It is in the category of borrowed dollars that the words “risk” and “interest” rate become important. **Interest** is what you pay a lender for having used the money. **Risk** is the degree of danger the lender has in losing the money loaned to you. Normally, the higher the risk, the higher the interest rate you will be charged.

**What determines risk is the amount of shortcoming in any of the following:**

- management ability of the principals
- equity invested by the principals
- debt load — will the earnings be sufficient to meet all required obligations?
- security

If your loan proposal is a safe one, you will have relatively little trouble in obtaining the financing. If your proposal is judged to be risky, your interest rate might be higher and you could have difficulty finding a lender. The term of the loan may also have to be shorter.

## **CAN A RETAILER GENERATE FUNDS FROM WITHIN THE BUSINESS?**

While there is no guarantee that you can generate your financing from within your retail business, unless you had established a fund from prior years' profits, you should do a close examination of your business.

All areas affecting working capital such as accounts receivable, accounts payable, and inventory should be questioned to see if any changes could make additional funds available. The changes could be basic resulting from questions such as: Do my receivables need tightening up and are there past due accounts I can collect? Am I paying my accounts payable too soon and, if so, can I negotiate longer terms with my suppliers? Do I have slow moving items in my inventory that could be discounted for a special sale?

Preparing a cost analysis can help you verify that there are no unprofitable activities or products in your business. Make sure all your fixed and movable assets are contributing to the profits of your business. An example of a noncontributing asset would be owning a delivery truck that spends more time parked behind your store than it does making deliveries.

This type of examination, which should be done periodically, can help you in determining your financial requirements by showing up any weaknesses in your business. This is in addition to possibly being able to generate funds from within to supplement or replace outside borrowings.

## **HOW DOES A RETAILER ESTABLISH A CREDIT RATING?**

It is very important to have a good credit rating. Both suppliers and lenders, when considering the financing of your retail business, will refer to your credit rating. Your credit rating is a major factor in determining the amount of the loan or the extension of credit to you.

If you are a new retailer, how do you establish a credit rating? The easiest and quickest way is to get in touch with the local office of a reputable credit reporting agency. In Canada, a retailer has a choice of both national and international credit reporting agencies as well as several specialized agencies that serve certain types of business or particular areas of the country.

A credit reporter will contact you to obtain financial statements of your business and possibly yourself if your business is in its first months of operation. You may be asked to supply information such as the history, operation, payment record, finances and banking of your business. Personal and business references can also be requested. The credit reporter might obtain additional information from your chartered bank (what your banking history is), your suppliers (your payment history — slow or prompt), and the public record (judgements, non-responsibility notices, registered chattel mortgages, and bankruptcies).

All this information is compiled into a brief synopsis of the business, its estimated financial strength, and a credit appraisal based on the assessment of such factors as management, survival and growth ability, and payment records. This report, referred to as your credit rating, is available for your inspection if you so wish. Most businesses recognize that it is better to supply credit reporting agencies with full and accurate information resulting in a correct rating than run the risk of their file not being complete or current.

To maintain a good credit rating, you should make all payments on time. If you can't, let your creditors know immediately and tell them why. Arrange a partial payment if possible, but keep your creditors informed of delays. This will continue to show responsible management and can help to protect your credit rating.

## WHAT PAPERWORK DOES A RETAILER NEED WHEN SEEKING FINANCING? AND WHY?

Many retailers, when going to a lender or an outside equity investor, are sometimes perplexed by the demands for information and paperwork put to them. Is all this information and paperwork really justified? What is it needed for?

While you know what your retail business is all about, the person whom you have approached for financing will not know it in the same detail. Naturally, he or she will want to learn as much as possible about the business to be financed.

It is very easy to view a lender or investor as an adversary. Is this not someone whom you must do battle with to get your financing? Aren't the information requests craftily designed to embarrass you and to justify the decision not to give you a loan? And wasn't that decision made upon first hearing about you?

Of course the answers are no. A lender or investor is in business to supply money. And you, the retailer, want to explain **why your** business should be financed. Because you are the one who best knows your business, and because you must prove that a loan or investment in your business will not result in a loss, it is to your advantage to give as much information as possible.

Good management is the key to success in your retail business and is the major assurance to a lender or investor that money put into your business is safe. Good management must show in your financing proposal.

Let's examine what information and paperwork is required and why a lender or investor wants it. Not every lender or investor will ask for all this paperwork and some requirements may not be applicable to your retail business. But it is best to be prepared.

## THE ESTABLISHED RETAIL BUSINESS

### Paperwork

1. Resumé of the business :
  - when started
  - who started
  - why started
  - where located
  - legal structure
  - operating details
  - product details
  - major suppliers & customers
  - advantages business has
2. Resumé of the principals and key people working in the business :
  - education
  - experience
  - why valuable to the business
3. Financial statements for the last 5 years; if less than 5 years, as many years as possible :
  - profit and loss
  - balance sheet
  - statement of retained earnings
4. Prepare a profit and loss statement for the current year and for at least the next 12 months (your forecast). Will be important to justify calculations, especially sales.

### Why

- Describes the basic non-financial background of the business. Shows the lender or investor what the business is all about.
- Describes who is who. A business is people and people make the management. This allows the lender or investor to assess management abilities.
- Provides the financial background of the business. Allows the lender or investor to analyze the assets, liabilities, historical growth, the initial equity and the shortfalls. Shows what the business is worth. Gives a financial assessment of the management abilities.
- Will show the future of the business: survival, growth, ability to repay loan, return on investment. Indicates anticipated sales and profits. Shows the direction of the business.

## Paperwork

## Why

- |   |  |
|---|--|
| 5. Cash flow for at least 12 months. Inventory needs must be justified as well as revenues. Include the loan proceeds.  | ● Shows why the loan is needed. Shows cash highs and lows. Will indicate to lender where problems can occur in repayment. Shows inventory levels and when cash required. Will show if loan amount justified — needs may be greater than loan and more financing may be required. |
| 6. Personal financial statements  | ● Will show lender or investor if there is any additional financial support in case the business gets in trouble — what the business has to fall back on.  |
| 7. List of security available for the business: <ul style="list-style-type: none"><li>● description</li><li>● when bought</li><li>● price when bought</li></ul>   | ● Required if loan has to be secured by fixed or movable assets, especially if chattel mortgage necessary.   |
| 8. Copy of lease  | ● Will substantiate rent payments, restrictions, and penalty in case of default. (Restrictions can be limits as to number of sales a year, what fixtures can be installed.)  |
| 9. Insurance policies on the business   | ● Lender and investor want to know if business insured against losses and liabilities and who is the beneficiary.  |
| 10. If you own the building: <ul style="list-style-type: none"><li>● copy of mortgage</li><li>● building specifications</li><li>● amount of paid up mortgage</li><li>● any liens</li><li>● recent appraisals if any</li></ul> | ● Will show lender and investor the situation re this major security item. Appraisal may show building worth more than book value.   |

# THE NEW BUSINESS BEING STARTED UP

## Paperwork

1. Resumé of the principals and key people (if known) who will work in business:
  - education
  - experience
  - why valuable to the business
2. Personal financial statements
3. Financial statements for your proposed first year of operations:
  - profit and loss
  - balance sheetWill be important to justify calculations, especially your forecast of sales.
4. Cash flow for at least 12 months. Inventory needs must be justified as well as revenues. Include the loan proceeds.
5. List of security available for the business:
  - description
  - when bought
  - price when bought

## Why

- Describes who is who. A business is people and people make the management. Allows the lender or investor to assess management abilities.
- Will show lender and investor the financial background of principals; valuable especially if never in business before. Will show if there is any additional financial support in case the business gets in trouble — what the business has to fall back on.
- Will illustrate the anticipated operations of the business. Will indicate anticipated sales and profits. Shows why the loan is needed. Allows the lender or investor to analyze.
- Shows cash highs and lows. Will indicate to lender where problems can occur in repayment. Shows inventory levels and when cash required. Will show if loan amount justified — needs may be greater than loan and more financing may be required.
- Required if loan has to be secured by fixed or movable assets, especially if chattel mortgage necessary.

6. Copy of lease

- Will substantiate rent payments, restrictions, and penalty in case of default. (Restrictions can be limits as to number of sales a year, what fixtures can be installed.)

7. If you own the building:

- copy of mortgage
- building specifications
- amount of paid up mortgage
- any liens
- recent appraisals if any

- Will show lender and investor the situation re this major security item. Appraisal may show building worth more than book value.

A new retail business will have its forecast and cash flow closely scrutinized by a lender or investor. There are no past records to prove that the business is a viable venture. You must be sure your estimates of sales, expenses, and profit are realistic and can be justified. Most importantly, your levels of inventory will have to be carefully forecasted. You, as a new retailer, may be asked to substantiate any terms of credit or arrangements that you have made between your business and your suppliers. Having to pay C.O.D. for your inventory when you were expecting terms of net 30 to 60 can play havoc with your financial planning.

Both a new and established retailer could be asked to produce a business plan stating goals and objectives covering the next three to five years of operations. For this future period of time, you may be asked to identify your short and long-term money needs as well as your plans for financing these needs. You may also be questioned on your personal insurance arrangements and what happens to the business in the event of your death.

To get financing, the burden of assuring that a loan or investment in your business will not be lost is with you. Your only method to demonstrate this assurance is by the use of paperwork and information.

It is advisable at this point in this chapter to stress the importance of your paperwork, especially your financial statements, your forecast and your cash flow. Accuracy is crucial. You may

wish to consider at this stage qualified help in the preparation of your financing proposal. Even with this qualified help, make sure you understand your proposal. Your financial statements, your forecast and cash flow prove not only to the lender or investor that your business is viable but also to yourself. Don't forget you have an investment in the business too.

## WHAT IS THE PROCEDURE IN APPLYING FOR RETAIL FINANCING?

Your first step is to determine the amount of financing your retail business needs. In determining the amount, you will have to prepare a forecast, a cash flow, a profit and loss statement and if a new business, a set of financial statements for your proposed first year of operation.

Your second step, in conjunction with the above, will be to analyze your business and determine whether you can find all or a portion of the required funds from within your retail business.

Your third step can be an initial contact with a lender or investor to find out what paperwork you will be required to present with your application. Or, you can go ahead and prepare as much paperwork as you think will be necessary.

The completeness of your initial approach, in the sense of having as much documentation as possible, will show management ability on your part, as well as speed up the process of your application. It can make more sense, instead of asking what paperwork is required and then at a later date bringing it in, to show up with more paperwork than is necessary and start talking financing right away.

It is important to schedule the interview and to allow yourself time to get the financing. Nothing gives a poorer impression than a "I need it tomorrow" financing request.

Your fourth step is one of communication. Explain your business and **why** you should be given financing. Be free with your informa-

tion and, at the same time, find out all you need about the financing: terms, payment, interest rates, security requirements, front end charges and related fees. Don't commit yourself without a complete understanding of what is involved.

Your fifth step may be getting additional information or substantiating, for the lender or investor, statements that you have made. This could include such things as verifying your sales figure, confirming term credit with your suppliers, or detailing your year's inventory requirements.

What happens if you are turned down? Find out why. Use the lender's or investor's experience to your advantage. Find out what is wrong or weak in your proposal. Correct it and see if you can reapply. Have you chosen the right type of financing and the right type of lender or investor for your retail needs?

Maybe the answer is yes to your application but includes an "if". At this point you must decide if you can accept the lender's or investor's conditions for the loan. Are the conditions severe restrictions or standards that place too drastic a curtailment on your operations? Are you committing yourself to more than you intended? Or, are these conditions normal financing requirements? You must be sure of the effect the conditions will have on your business.

Once you get the loan or investment keep in touch with the people who have financed your retail business. Send regular statements and progress reports. You never know when you may need additional financing and, by having kept your lender or investor in the picture, you will speed up your next application.

## CONCLUSION

Good management is the key to success in your retail business and is the major assurance to a lender or investor that money put into your business is safe. Good management must show in your financing proposal.

### 3. RETAIL PRICING

*"There is far more to a successful retail pricing strategy than just applying a price tag. Behind the price tag is good management."*  
— CASE counsellor

INTRODUCTION .....	58
RETAIL PRICING DEFINED .....	58
MARKUP ON COST AND MARGIN ON SELLING .....	59
FINDING THE ESTABLISHED MARKUPS .....	60
CAN YOU AFFORD THE ESTABLISHED MARKUP? .....	62
THE PRODUCT MIX .....	65
FACTORS AFFECTING RETAIL PRICES .....	66
MARKDOWN AND LOSS LEADERS .....	70
BEFORE YOU INCREASE THE RETAIL PRICE .....	71
A PRICING CODE SYSTEM .....	74
A PRICING CHECKLIST .....	75
CONCLUSION .....	78

## INTRODUCTION

What the customer will buy and in what quantity are often determined solely on a retailer's prices. This in turn directly affects the retailer's revenue and, ultimately, profit.

Effective retail pricing, therefore, should be considered as a vital component of good management. To many retailers, pricing is an art learnt by experience and constant practice. But whether you are a new retailer or an established retailer, you should be constantly monitoring your pricing strategy.

This chapter introduces you to some aspects of retail pricing. It looks at the concept of retail pricing, what your retail price must cover, the product mix, pricing by competition and market, psychological pricing, and the use of loss leaders and markdowns. As well, it includes a simple price coding system and a pricing checklist to help you monitor your pricing strategy.

## RETAIL PRICING DEFINED

Retail pricing can be simply defined as applying a selling value to merchandise for sale.

Like most definitions, this one fails to give the complete story. As a retailer, pricing will be a major sector of your business in which you will be constantly concerned. The prices that you set must be competitive with other retailers' prices or your customers will shop elsewhere. Yet, at the same time, your prices must be set high enough so that the difference (markup) between your costs and sales will cover all your operating and selling expenses and, most importantly, give you a reasonable profit.

Your pricing strategy must be flexible so that it takes advantage of opportunities such as customer demand, or recoups mistakes such as overstocked or slow moving inventory. A retailer's pricing strategy must also include the use of prices to promote the business, be it special sales, deep discounts or loss leaders. Pricing must reflect a retailer's product mix insofar as knowing which products can take a high markup and which products a low markup without adversely affecting the business's total gross profit.

# MARKUP ON COST AND MARGIN ON SELLING

To examine retail pricing, we should first look at two common terms used by retailers: **markup on cost** and **margin on selling**. It is important to understand these terms, especially, when expressed as percentages.

**Markup on cost** is the difference between cost of merchandise and retail price. The cost of the merchandise is usually the base invoice price plus any delivery charges and minus any payment discounts (e.g. 2% 10 days) or quantity discounts. The retail price is what the customer pays for the merchandise.

**To calculate markup on cost as both a dollar figure and as a percentage, retailers use the following simple formulas:**

Retail price – Cost of merchandise = Dollar markup  
Dollar markup ÷ Cost of merchandise = Percentage markup

If you are selling a product at \$12.50 and you subtract your cost of \$10.00, your markup on cost as a dollar figure is \$2.50. To find the percentage, divide the dollar markup on cost by the cost (\$2.50 ÷ \$10.00) and the answer is a 25% markup on cost.

**Margin on selling** is a percentage calculation that allows you to find out what percentage your dollar markup on cost is of your retail price.

**Retailers use this formula to calculate the percentage of margin on selling:**

Dollar markup ÷ Retail price = Margin on selling

In our previous example, the product that sold for \$12.50 had a dollar markup on cost of \$2.50. Dividing the dollar markup figure by the retail price gives us a 20% margin on selling (\$2.50 ÷ \$12.50 = 20%).

When making comparisons of their businesses to statistics or when deciding their price strategies, retailers are careful not to confuse the terms and percentages of markup on cost and margin on selling. The following table shows the percentage equivalents between markup on cost and margin on selling:

**Markup on cost  
percentage (%)**

10.0  
15.0  
20.0  
25.0  
30.0  
33.3  
35.0  
40.0  
45.0  
50.0  
60.0  
66.7  
75.0  
100.0

**apply the above  
markups on your  
cost price**

**and**

**Margin on selling  
percentage (%)**

9.0  
13.0  
16.7  
20.0  
23.1  
25.0  
26.0  
28.5  
31.0  
33.3  
37.5  
40.0  
42.8  
50.0

**you will obtain  
these margins on  
your selling price**

## **FINDING THE ESTABLISHED MARKUPS**

Pricing strategy, with its adjustments of retail prices, should not begin until the retailer has found out what the established markups are on the merchandise to be sold. This is especially a problem for the new retailer who must base his forecasts of gross trading profit on the most accurate estimates possible.

**Many retailers determine established markups on merchandise by using the following sources:**

- wholesalers (travellers)
- manufacturer's suggested list price
- other retailers
- auditors, accounting firms
- personal observation

**Wholesalers (travellers)** will be your primary source of information on what markups are possible on merchandise the traveller is wholesaling. The traveller will have partially based the suggested markup on what his or her other retailer customers are applying. As well, the traveller is in competition with other wholesalers and will know the wholesale market which includes the suggested markups for retailers. The traveller's suggested markups are usually fairly dependable. The traveller will not wish to lose you as a customer which would happen if you found the suggested markups to be noncompetitive.

**Manufacturer's suggested list price** is a selling price established by the manufacturer. The purpose is to provide the manufacturer with a uniform pricing presentation at the retail level thereby keeping the product in a certain price quality bracket. Sometimes the suggested list price is printed on the package containing the product. The markup allowed to the retailer by the suggested list price is usually sufficient to cover, on a per item basis, the retailer's operating and selling expenses. As well, there is enough leeway in the markup to allow price adjustment.

**Other retailers** can be a source for established markups. This includes both retailers in locations that are noncompetitive to you as well as your direct competition. A noncompetitive retailer may be quite willing to give you markup information as well as other advice. The retailer, with whom you will be in direct competition, will be far less inclined to discuss markups. In this case, you will have to find out the wholesale costs of products and match them to the competitor's retail prices. It is important to condition your comparison with other retailers by factors such as location, size, and market.

**Auditors, accounting firms** can be another source of information for established markups. This can be especially true if you are, or will, use an auditing or accounting firm that deals with other retailers. Of course, a certain amount of confidentiality with accountants and their clients must be respected.

**Personal observation** is another source of markup information. This may entail reading trade journals, catalogues and other written materials. It might include visits to suppliers and manufacturers. Retail associations are also a personal contact source not to be

overlooked. Friends or acquaintances may work in or own a retail establishment similar to one you have planned or have established. They may be willing to talk about their pricing structures. If in the early planning stages of a retail operation of your own, have you considered working in a similar retail concern for six months or so to gain information and experience?

A final comment should be made on established markups. There is no mystery to established markups. Today's markups result from trial and error over many years and represent a fine sifting of the many factors in each line of goods. There are traditional markup patterns expressed as averages for the many types of retail businesses. Once you know the established markup the next question is one of determining whether or not you can afford to be in business at the established markup.

## **CAN YOU AFFORD THE ESTABLISHED MARKUP?**

Imagine that your research into established markups has shown that a 25% average markup can be applied to the type of merchandise you plan to sell. Does that mean you immediately go ahead and use that markup? Your answer should be no. Before applying a markup, most retailers will first determine if their sales will be sufficient with that markup to give enough gross trading profit to (a) cover all selling and operating expenses and (b) to provide a reasonable net profit.

### **The following steps are suggested in determining what markup on cost a business can afford:**

- add up the yearly operating and selling expenses
- estimate sales
- calculate cost of goods sold
- obtain the gross trading profit
- obtain the operating profit
- see if the venture is viable

The new business, unlike the existing business, will not have the benefit of previous years' profit and loss statements. Therefore, the estimates of sales, expenses, and profit must be realistic.

To determine whether or not your retail business can afford the established 25% markup on cost (20% margin on selling), you have prepared the following forecast:

## FORECASTING TO CHECK THE MARKUP

	\$	\$	Percentage of sales
Sales	200,000		100%
Cost of goods sold	<u>160,000</u>		<u>80%</u>
Gross trading profit	<u>40,000</u>	40,000	20% *
Expenses :			
Wages (part-time staff)	2,300		
Rent	6,000		
Light, heat & power	1,000		
Insurance	800		
Advertising & promotion	2,300		
Office & accounting	400		
Building maintenance	300		
Telephone	300		
Delivery	1,200		
Loan interest & bank charges	200		
Depreciation	<u>200</u>		
Total expenses	<u>15,000</u>	<u>15,000</u>	
Operating profit		25,000	12%
Owner's withdrawals		<u>15,000</u>	
To surplus		<u>10,000</u>	5%

\* It is important, when comparing your retail business to previous periods of time, to refer to this percentage. A reduction here, even if sales have increased, will generally mean your operating profit is going down.

Let us analyze your forecast and see how you prepared it and what conclusions you are able to make.

**Add up the yearly operating and selling expenses** was your first step in preparing the forecast. This part of the forecast lists both fixed costs such as your rent, insurance and variable costs such as wages and telephone. In forecasting expenses without the benefit of prior years' financial statements, it is important to be accurate. Errors, if any, should be in overestimating the expenses.

**Estimate sales** was the most difficult part of doing your forecast. You had to honestly determine what your share of the market would be. You had to know the kind of customer and quality demand you would have in relation to your merchandise. If your product is a high priced item, you determined your sales figure by multiplying the number of items you estimate to sell by the selling price. If you are going to carry a large number of products with a low price, your sales figure was determined on a volume basis. In all cases, you may have determined your sales based on a percentage estimate of your share of the market.

**Calculate cost of goods sold** was done by adding the wholesale cost of your merchandise along with any delivery charges in bringing the merchandise to your shop. The figure for cost of goods sold is, of course, in direct relation to your anticipated sales.

**Obtain the gross trading profit and obtain the operating profit** are simple calculations. Your forecasted operating profit is \$25,000 or 12% of total sales. As the owner, you plan to withdraw \$15,000 for your personal expenses and leave \$10,000 to surplus which is 5% of total sales.

Your conclusion, after analyzing the forecast, is that your business is viable at the established overall markup of 25%. This, of course, depends on actually selling what you have estimated you will sell and on not exceeding your estimated expenses.

Had your business not been a viable operation at the established markup, increasing the markup would not necessarily have been the answer to make the business viable. Cutting back expenses, reducing drawings and trying to increase the volume of sales are the areas you would consider before increasing markups. (See section "Before you increase the retail price").

With a viable operation, you will probably ask yourself a number of questions such as: Am I making a reasonable profit? Could I improve it by selling more? Could I reduce my expenses? If I reduce my markup, will I sell more? If I increase my markup, will I sell less but obtain a larger gross trading profit?

These last two questions are part of a retailer's pricing strategy and lead us into the next section of this chapter which looks at the product mix.

## THE PRODUCT MIX

In the example forecast, we saw that an overall 25% markup on cost (20% margin on selling), with a realistic forecast of sales, means that the business is viable.

Not all the merchandise will have a 25% markup. Some products will have a smaller markup and others a higher markup. As a retailer, you must know this mix of markups which is part of your pricing strategy. You must also know the relationship (how one offsets the other) of these various markups by sales volume. The sales volume of low markups and high markups must, in total, obtain the overall 25% markup on cost (20% margin on selling) that you need to keep your business viable.

In checking the following example, you will see that the markup on cost varies. Some retail prices include the average 25% markup on cost, while others have markups ranging from less than 20% to over 40%.

The purpose of this type of exercise is to show the retailer which products, in what quantity and at what markup, have to be sold to generate what gross trading profit. This is shown on an individual product basis and in relation to the total required gross trading profit.

A successful retailer knows his or her product mix. When adjusting markups, the product mix must be kept in mind when trying to either reach or exceed the required gross trading profit.

To know the product mix, some retailers do the following type of forecasting exercise:

Product Classification		Cost Price	Retail Price	No. of Units to be sold	Annual Total Sales	Gross Trading Profit
		\$	\$		\$	\$
Blouse	A1	12.50	15.00	300	4,500	750
"	A2	14.80	18.50	300	5,550	1,110
"	A3	9.79	14.00	300	4,200	1,263
"	A4	16.35	19.00	300	5,700	795
Skirt	B1	14.25	16.50	200	3,300	450
"	B2	17.69	23.00	200	4,600	1,062
"	B3	18.10	22.60	200	4,520	900
"	B4	12.15	14.60	200	2,920	
Jacket	MM2	16.50	20.65	100	2,065	415
"	MM3	18.35	22.95	100	2,295	460
Sweater	SR1	12.49	16.25	300	4,875	1,128
"	SR2	11.00	14.30	300	4,290	990
"	SR4	9.85	12.80	300	3,840	885
Slacks	TT1	8.40	10.50	200	2,100	420
"	TT2	10.25	12.80	200	2,560	510
Scarves	W1	2.00	2.50	100	250	50
					200,000*	40,000*

\* Refer to the forecast on page 63.

## FACTORS AFFECTING RETAIL PRICES

The product mix, with its various markups, provides enough difficulties in obtaining the required overall markup. Yet, there are many factors related to the product mix and market conditions which the retailer must constantly keep up with in setting prices. Let us look at some factors that can affect your retail pricing.

**Reduction in wholesale price** can come about in a number of ways. The wholesale price may be reduced by the purchase of a larger quantity (quantity discount). The wholesaler may also reduce the price because the line is being phased out, or the product is slow moving and either the wholesaler or the manufacturer is overstocked. It may also be a case of the wholesaler wishing to promote a new

product, thereby offering a price reduction to encourage the retailer to stock and display the product.

When faced with a reduction in the wholesale price, the retailer must decide whether to carry the new stock at the old retail price, thereby obtaining a larger gross trading profit, or to reduce the selling price. Reduction of the selling price need not be in direct proportion to the reduction in the wholesale price. The retailer should adjust the markup to the best advantage of the business. This could mean a quick discount sale or maybe a lower selling price spread over both old and new stock.

It must be stressed that you should look closely at the reason why the wholesale price is being reduced. A bargain from the wholesaler ceases to be a bargain when it sits on your shelves too long in the unsold status. Slow moving or dead stock and the space it occupies cost you money.

**Increase in wholesale price** usually is less of a problem for your retail pricing than a reduction in the wholesale price. In most cases, your markup percentage will remain the same. Some retailers occasionally will water down the wholesale price increase by averaging it over existing stock purchased at the previous price. This is a method used in undercutting the competition.

**Slow inventory turnover**, as a factor affecting your retail pricing, will be determined by your inventory management. In other words, you will know what the correct inventory turnover rate should be for your business and the age aspect of your stock. (Rates are available from retail associations, accountants, Statistics Canada.)

If by adjusting your retail prices you can move the inventory as a whole (if needed) or move certain items, you may decide to have a special sale. This recognizes the fact that it may, at times, be better to sell more items at say 20% markup on cost than less items at a 30% markup. Dead or slow moving stock which, for too long a time, has tied up money and valuable space, is sometimes sold by the retailer with no markup or even at less than cost so as to realize cash. Many retailers have also found it wiser to give a substantial reduction in price immediately and sell the slow moving stock than to make small price reductions in stages when they find the stock is not moving quickly enough. Price reductions in stages

defeat the idea of a sale. People who have purchased at 10% off will not be happy when they see a sale extended with the same items marked 20% off. The next time there is a sale, and if they plan to buy at all, they will probably wait for further reductions. Sales should be short and attractive and be a marked contrast to regular prices.

**Competition** is your single major factor affecting your retail prices. If a retailer in direct competition to you is selling a product for \$12.99 and your price is \$14.39, chances are that, other things being equal, your customers will purchase at your competitor. This is why retailers do comparative "shopping" of their own by both visiting their competitors' shops and checking their competitors' advertisements. Be sure that *exactly* the same product is involved when comparing prices with your competitors. Model, size, weight, grade, etc. and quantities on hand must be the same. Often advertisements do not give all the product information.

In many cases, other tactics may have to be used to compete pricewise. This is especially true with the small retailer whose competition is a franchise or chain store or a giant retailer. The alternatives are the use of private brand merchandise that is not in direct price competition, or the use of non-price factors such as convenience hours, personal service, and presentation.

**Demand** is the measurement of the customers' wish to purchase a commodity. If the demand for a certain product or product line is high, then the retailer can charge a high markup. Though often a retailer in a situation of high demand will try for a larger sales volume by either keeping the normal markup or actually reducing it slightly. If the demand is low or nonexistent, the retailer will have to adjust his prices accordingly and use all strategy necessary to induce customers to purchase.

Demand is conditioned by supply, by seasons, by holidays and by trends. Demand which is a result of a trendy or gimmicky product must be handled carefully by the retailer. Good management must ensure that you take advantage of a trend in its early stages. You don't want to end up with a large stock of the novelty item and find the trend finished. No matter how much you lower your retail prices, you will have difficulty selling a *passé* novelty.

**Psychology** is also a factor affecting your retail pricing strategy. An item selling for \$29.99 has more consumer price appeal than the same item at \$30.00. The dollar figure is what registers first with most consumers.

Many retailers purposefully avoid ending their retail prices in even numbers or in 5's. This is especially true with items selling for less than one dollar. For example, if the normal markup on cost brings the retail price to 40¢, the retailer may show the retail price as 39¢ or 41¢ or 43¢. Most consumers, when seeing such odd numbers, will subconsciously think the price is *less* than what they were numerically expecting. The 39¢ price is thought of as *less* than 40¢ and the 41¢ and 43¢ prices as being *less* than 45¢. If the price was shown as 40¢ or 45¢ there would not be this subconscious reaction.

You must also remember the psychological aspect of setting prices on an individual basis and, at the same time, as a double unit. An example of double unit pricing is \$1.29 each or two for \$2.57. Some consumers will, for arithmetic ease, round the original price to the nearest 5 or 10 figure and double it to compare with the price for two. In this case, the comparison will be \$2.60 against \$2.57.

In adjusting retail prices psychologically on items costing less than a dollar, you must realize that this is affecting your gross trading profit. A retail price going from 40¢ to 39¢ means a 3% loss of margin on selling. While an increase from 34¢ to 37¢ means almost a 10% gain of margin on selling.

**Economic conditions** are usually a retail pricing factor that you can do little to change, but which you should consider closely. The economic situation of a region or locality may be booming or can be depressed. A depressed economy with high unemployment could mean you have to lower your markup on cost, while a healthy economy should permit larger markups. Your retail area may be one that has an intense summer tourist trade at which time your markups may be higher than during the rest of the year. Your area could also be one whose work force is affected by seasons such as forestry or fishing. In the off seasons, you may have to reduce your markup. There are some towns whose principal employer is a single company and, depending on the fortunes of the company

(layoffs, overtime, new hiring), the town's retailers will adjust their selling prices accordingly.

## MARKDOWN AND LOSS LEADERS

We have looked at markup on cost, so we should now look at the concept of markdown and the use of loss leaders.

**Markdown** should correctly be termed "markdown on selling" and be viewed simply as a decrease in the selling price. Markdown can be calculated as either a dollar figure or a percentage of the original selling price. For example, "25% off" means that, if an item was selling for \$13.99, the marked down price would be  $\$13.99 \times 25\% = \$3.50$ ;  $\$13.99 - \$3.50 = \$10.49$ .

It is important to remember that a decrease in the selling price will mean that your markup on cost has been reduced but *not* by the same percentage. In the above example, if our item costs \$9.79 and sold for \$13.99 then the markup on cost was \$4.20 or 42.9% (30% margin on selling). The decreased selling price is \$10.49 which means a markup on cost of only \$0.70 or 7.2%. The 25% off selling has meant the markup on cost has been reduced not by 25% but by 35.7%.

From the above, it becomes apparent that markdowns should not be indiscriminately applied. Remember your product mix and that your overall sales must give you your required gross trading profit. Markdowns should therefore be mainly used in cases such as having dead or slow moving stock, sudden competition on a particular item, or having initially priced an item too high.

Of course, in knowing your product mix and mix of markups, you may have also found that you have reached the requested unit volume of sales on a particular item and can afford to lower your markup to attract customers..

**Loss leaders** are items that are sold at very attractive prices for consumers. The purpose is to generate customer traffic in your shop. The hope is that these customers, as well as buying the loss leader, will either make other purchases of regular stock or will return remembering your shop's low prices.

The use of loss leaders is usually for a short-term basis and is accompanied by sales promotion. There are mainly two sources for these loss leaders. The first source is your own stock where you decide to knock down the selling price of a particular item. (Note that usually you will not use dead or slow moving stock as loss leaders). The second source is the wholesaler or manufacturer who will specifically sell items to the retailer at reduced prices. These can be items new to the market or currently in favour. Often the wholesaler or manufacturer is able to supply promotional material such as posters and flyers. If more than one retailer in a given area is involved with a loss leader, sometimes common advertising in newspapers or on radio is arranged.

**Note:** Retailers must comply with consumer protection laws that can ask a retailer to prove the original selling price.\* For example, if you are selling an item at \$10.49 and the original selling price was \$13.99 you cannot, by law, show the original price as being \$19.99. Be careful of your use of such words as “regularly”, “was”, “originally”, “reduced from” in reference to your retail prices. You may be asked to prove a “was” price and, if you cannot, your business is liable to be fined.

## BEFORE YOU INCREASE THE RETAIL PRICE

Imagine this situation: The dollar figure for your sales is down and your gross trading profit will soon be insufficient to cover your operating and selling expenses.

Your immediate reaction, under these circumstances, might be to increase your markup. This is a natural reaction as markup has such a direct effect on the gross trading profit.

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\* The offence is where your price representation is materially misleading. “Material”, as used in the expression materially misleading representation, is not the value to the purchaser but rather the degree to which the purchaser is affected by these words in deciding whether or not to purchase. (Section 36 *Combines Investigation Act*)

Most retailers though, before increasing their retail prices, will first see if their *volume* of sales can be increased. Increasing the volume of sales will, in turn, increase their gross trading profit. Increasing the markup will increase the dollar value of sales, but there is a good chance that with higher prices you may lose customers and your volume of sales may go down. If that happens, your higher markups will not have improved the situation at all.

**To increase their sales volume, many retailers will look at three areas of their retail business:**

- premises
- presentation
- merchandising specials

**Premises**, and their condition, create both a conscious and subconscious reaction with customers. This is especially true of potential customers who will initially make a judgment of your shop on appearances.

Knowing this initial reaction, you should ensure that your premises are inviting. Well lit, in good repair, painted and clean, are adjectives that usually are applicable to a successful retail business. Shop windows and outside signs deserve special attention as to condition. These are two important facets that are seen first by customers.

**Presentation** has a broad application to your retail business. It should be viewed as making the customer feel welcome and wanted. Signs in your window should be up-to-date and have a professional appearance. Your window display should be current and clean and varied on a rotation basis. Inside your shop your merchandise should be well presented, priced clearly, and have a logical relationship. For example, a hardware store should have all its paints in one section along with brushes and related painting materials. This will show the customer your complete stock types and can induce him or her to buy related products. Your merchandise should also be clean and easily visible. Shelves should look neither overstocked nor bare.

Your salesclerks are a very important aspect of presentation. Are they friendly? Do they make the customers feel wanted or do they idly stand waiting for the customers to come up to them? Are they completely familiar with your merchandise and can they suggest alternate or related items to the customers? In non-peak hours, do they keep the merchandise tidy and otherwise keep busy?

**Merchandising specials** is your third method in which to try to increase your sales volume. This is where loss leaders are used or controlled markdowns are taken on popular merchandise. The sale is short and there is extensive advertising both before the actual sale and during the sale itself. The idea behind the sale is to induce people to purchase your regular stock as well as the sale stock and to remember your store as a place for good prices.

When you finally have to increase your retail prices, do not apply a higher markup to all your stock at one go. Be selective, analyzing which items can take an increase in markup and which items the customer will know are higher. Maybe change brand names and apply the higher markup to the new product so that people associate the higher retail price with the brand name and not so much with the product.

Remember to make your increases in relation to your product mix as described on page 65. Also remember that nothing looks worse than a price sticker applied on top of another one. Two price stickers\*, applied in this manner, immediately tell the customer the price has gone up. For, if the retail price had gone down, the customer knows you would clearly show the saving as an encouragement to buy.

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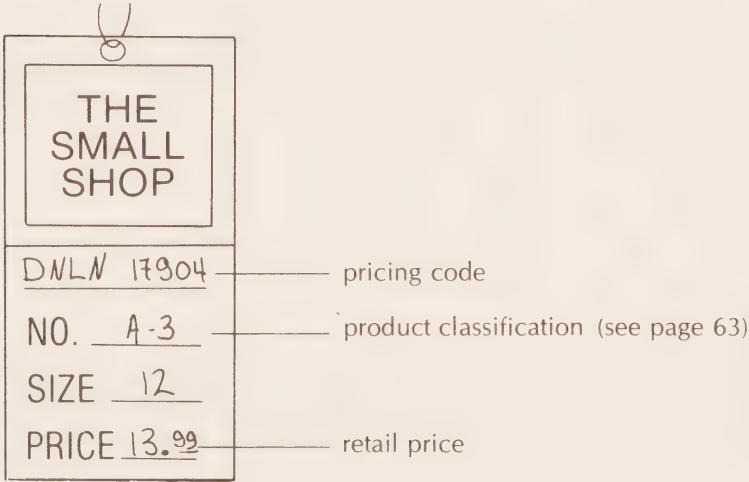
\* Where two or more prices are clearly shown on a product, its container or wrapper, etc., the product must be supplied at the lower price. This provision does not actually prohibit the existence of two or more prices but requires that the product be offered for sale at the lower price. (Section 36.2 *Combines Investigation Act*)

# A PRICING CODE SYSTEM

At the beginning of this chapter and throughout the text, we have stressed the importance of constantly monitoring your pricing strategy and knowing your merchandise. Knowing your merchandise means knowing when you purchased the product, how much it cost you, what the markup is, and what the selling price is.

It is important to know these facts about your merchandise as they are mandatory for any decisions that you make in price adjustments. How do retailers obtain this information so quickly? We have all seen the situation where a customer is hesitating over a purchase and the retailer, giving a quick glance at the price tag, makes a special price and the customer buys. A retailer may suddenly put a certain product line on sale for a few days or maybe, once a week, have a regular advertised special. How is this done so quickly?

While decisions of pricing strategy are backed up by accounting and inventory records, many retailers by referring to their retail price tags are able to avail themselves of immediate merchandise information. Let us look at a retailer's price tag and see what is on the price tag, in addition to the retail price.



Our retailer giving a quick glance at the above price tag knows, by the pricing code, that the item's total original cost is \$9.79 and was taken into inventory in April 1979. The markup on the cost is \$4.20. With this information, our retailer is able to make a decision on a price adjustment if the sales conditions so warrant.

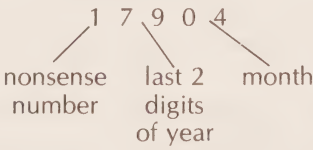
To establish such a pricing code, take any 10 letter word that does not repeat any letters and, in order, assign each letter with a number from 1 to 0. In the above example, our retailer used:

C U M B E R L A N D  
1 2 3 4 5 6 7 8 9 0

The original cost of this tagged item was \$9.79 or:

D N L N  
0 9 7 9

The second part of the code establishes the date the item was taken into inventory. In our example:



The above pricing code is but an example. Any code can be used that serves your purpose, but remember that it must be a simple code that you can learn and read as easily as you would the actual information. But be sure that your pricing code is not so uncomplicated that your customers will decipher it. Especially with the code for age of the item, you may wish to add some more nonsense numbers to avoid detection.

A PRICING CHECKLIST

This section consists of a checklist for you to complete. Some of the questions have been examined in this chapter, while other questions are there as an inducement for you to enquire further into the aspects of retail pricing. You may also wish to periodically use this checklist as an aid in monitoring your pricing strategy.

## Questions

	YES	NO
<b>Markup on cost and Margin on selling:</b>		
Do you know what markup on cost is?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what cost of merchandise includes?	<input type="checkbox"/>	<input type="checkbox"/>
Can you calculate markup on cost as a percentage?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what margin on selling is?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the formula for finding percentage of margin on selling?	<input type="checkbox"/>	<input type="checkbox"/>
Do you really know the difference between markup on cost and margin on selling?	<input type="checkbox"/>	<input type="checkbox"/>
 <b>Finding the established markups:</b>		
Will you contact a wholesaler for markup information?	<input type="checkbox"/>	<input type="checkbox"/>
Will you use the manufacturer's suggested list price?	<input type="checkbox"/>	<input type="checkbox"/>
Can other retailers supply you with markup information?	<input type="checkbox"/>	<input type="checkbox"/>
Could an accountant or auditor give you markup information?	<input type="checkbox"/>	<input type="checkbox"/>
Are you going to visit suppliers and manufacturers?	<input type="checkbox"/>	<input type="checkbox"/>
Can a retail association help you?	<input type="checkbox"/>	<input type="checkbox"/>
Have you found the average markup on cost for the merchandise you will sell?	<input type="checkbox"/>	<input type="checkbox"/>
 <b>Can you afford the established markup?</b>		
Do you know what a markup on cost must cover?	<input type="checkbox"/>	<input type="checkbox"/>
Have you prepared a forecast to check what markup you can afford?	<input type="checkbox"/>	<input type="checkbox"/>
Are your yearly operating and selling expenses estimated accurately?	<input type="checkbox"/>	<input type="checkbox"/>
Have you calculated cost of goods sold in relation to your sales volume?	<input type="checkbox"/>	<input type="checkbox"/>
Is your sales figure accurate?	<input type="checkbox"/>	<input type="checkbox"/>
Have you analyzed your sales figure?	<input type="checkbox"/>	<input type="checkbox"/>
Have you correctly applied your markup on cost to your cost of goods sold?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Will your gross trading profit be sufficient to cover all operating and selling expenses and give you an adequate return?	<input type="checkbox"/>	<input type="checkbox"/>
Will your business be viable at the established markup?	<input type="checkbox"/>	<input type="checkbox"/>
<b>The product mix:</b>		
Do you know your mix of products and markups?	<input type="checkbox"/>	<input type="checkbox"/>
Have you estimated the sales volume of each product?	<input type="checkbox"/>	<input type="checkbox"/>
Will you know when you can adjust your markups?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Factors affecting retail prices:</b>		
Do you know why a wholesaler would reduce the wholesale price to you?	<input type="checkbox"/>	<input type="checkbox"/>
Have you decided what to do with your markup if the wholesale price is reduced?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know why a wholesale price will go up?	<input type="checkbox"/>	<input type="checkbox"/>
Will you spread the wholesale price increase over both old and new stock?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the correct inventory turnover rate for your business?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the age of your stock?	<input type="checkbox"/>	<input type="checkbox"/>
Do you realize what dead or slow moving stock means?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know why a sale should be short and attractive?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know at all times what your competitors are charging?	<input type="checkbox"/>	<input type="checkbox"/>
Do you visit your competitors and check their advertising?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the effects created by demand, both high and low?	<input type="checkbox"/>	<input type="checkbox"/>
Are you selling a novelty or seasonal item and are you aware of the risks?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the psychology of pricing?	<input type="checkbox"/>	<input type="checkbox"/>
Do you end your prices in odd numbers?	<input type="checkbox"/>	<input type="checkbox"/>
Do you offer quantity prices to your retail customers?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware that your margin on selling will change when adjusting your prices psychologically?	<input type="checkbox"/>	<input type="checkbox"/>
Have you considered the economic conditions of your area or region and will you adjust your markup accordingly?	<input type="checkbox"/>	<input type="checkbox"/>

### **Markdown and Loss leaders:**

**YES**      **NO**

Can you define a markdown?	<input type="checkbox"/>	<input type="checkbox"/>
Can you calculate markdown in relation to the original selling price?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know when to apply markdowns?	<input type="checkbox"/>	<input type="checkbox"/>
Can you define a loss leader?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the sources of loss leaders?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know when to use loss leaders?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of consumer protection laws in reference to false pricing?	<input type="checkbox"/>	<input type="checkbox"/>

### **Before you increase the retail price:**

Can you increase your sales volume to boost your gross trading profit?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know three methods for increasing sales volume?	<input type="checkbox"/>	<input type="checkbox"/>
Are your premises inviting?	<input type="checkbox"/>	<input type="checkbox"/>
Is your merchandise well presented?	<input type="checkbox"/>	<input type="checkbox"/>
Are your clerks friendly and knowledgeable about your merchandise?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how to use merchandising specials?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what is involved in an increase in your retail prices?	<input type="checkbox"/>	<input type="checkbox"/>

### **A pricing code system:**

Do you have quick and accurate knowledge of your merchandise?	<input type="checkbox"/>	<input type="checkbox"/>
Have you a pricing code system?	<input type="checkbox"/>	<input type="checkbox"/>
Are you familiar and at ease with your pricing code system?	<input type="checkbox"/>	<input type="checkbox"/>

## **CONCLUSION**

Retail pricing, which is a crucial art to a retailer, cannot be taught or learnt in a few easy lessons. Retail pricing, like all aspects of good management, must be constantly worked at. The results of a successful retail pricing strategy, good retail prices should really be referred to as good management.

## 4. MANAGING YOUR RETAIL INVENTORY

*"Good retail inventory management helps to ensure that you have the right product in stock for the right customer at the right time."*  
— CASE counsellor

INTRODUCTION .....	80
DEFINING INVENTORY MANAGEMENT .....	80
NO INVENTORY MANAGEMENT: WHAT CAN HAPPEN? ...	81
PHYSICAL INVENTORY CONTROL .....	83
DOLLAR MERCHANDISE PLAN .....	88
OPEN-TO-BUY .....	93
FACTORS AFFECTING INVENTORY .....	95
DANGER SIGNALS IN INVENTORY MANAGEMENT .....	98
GLOSSARY OF INVENTORY MANAGEMENT TERMS .....	100
CONCLUSION .....	103

## INTRODUCTION

Good retail management includes managing your inventory. Basically, there are two reasons why you must manage your retail inventory.

The first reason is to ensure sales. Your retail prices may be effective and your shop may be in an advantageous location. Yet if you do not have the right product in stock for the right customer at the right time, your sales will be poor which, of course, will then affect your profit.

The second reason is one of finance. Like the majority of retailers, most of your money will usually be tied up in your inventory. Overstocked or slow moving inventory means that you have less ready cash to meet expenses and to purchase new inventory.

The purpose of this chapter is to introduce to you the concept of retail inventory management. It looks at the reasons for managing inventory; the benefits; physical control; the dollar merchandise plan which includes the aspects of merchandise budget plan, sales to stock ratio, as well as turnover; and open-to-buy. This chapter also examines what affects inventory and what danger signals to look for as part of your inventory management. A brief glossary of inventory terms is included as well.

## DEFINING INVENTORY MANAGEMENT

As a retailer, your aim is to derive maximum sales and profits from your merchandise. Your goal then is to have the ideal assortment of products.

Inventory management is the method used to ensure that your merchandise assortment is ideal. Inventory management means maintaining currently wanted merchandise in proper depth, price lines, colour and style so as to meet consumer demand.

Inventory management helps you answer the questions of: What should I buy? When should I buy? How much should I buy? As well, inventory management allows you to keep control over the dollars tied up in your inventory. It also helps you to ensure the correct balance of products in stock.

### **Inventory management can be expressed as:**

- a system of recording quantities on hand, on order and their respective rates of sale;
- implementing and maintaining, within a shop's overall budget and finances, the ideal assortment of merchandise;
- a carefully integrated sales program based on sufficient stock to achieve planned sales.

In other words, managing your retail inventory entails physical as well as financial controls. To further illustrate inventory management, this booklet next examines the situation of a certain newly established retailer.

### **NO INVENTORY MANAGEMENT: WHAT CAN HAPPEN?**

The practical application of inventory management for the retailer can be clearly shown in the following situation:

John and Mary Best have rented premises in the local shopping mall and have opened a hobby supply store. 'Best Hobbyshop' was an immediate success with the mall shoppers. Walk-in traffic is especially heavy on Friday nights and Saturdays because of the mall's supermarket. With the exception of a department store which has a small craft section, John and Mary have no direct competition. 'Best Hobbyshop' has customers and sales and, at first glance, is a success story. But the Bests ran into problems.

"I had to order some more of those macramé kits," said John looking at an almost empty shelf. "That's the third customer I've had this week who's gone away empty-handed."

"But why?" interjected Mary. "There are two boxes in the back that we haven't touched. Didn't you look?"

"Obviously I didn't," replied John with some irritation. "Are you sure we've got them in stock?"

The Bests checked and found they actually had three boxes. One box too many had been shipped but they had signed for it and it was on their account as well.

"Three boxes and now I've ordered two more which will be here tomorrow. Oh well, they'll sell eventually. These macrame kits move fast," observed John.

"That's what I thought with those gas-powered model boats," said Mary. "They seemed to be selling well, so we put the order in for I don't know how many. And now they're just sitting there gathering dust."

"It'll work itself out," observed John, "You'll see."

A number of weeks later, John was going through the latest wholesale kit catalogue.

"A lot of good stained glass kits are coming out. We should get our order in soon. There's a good profit to be made on glass kits."

"Where are we going to put them?" asked Mary. "There's no room for a good display. Plus we really don't have the money. We're way over what we thought we'd buy this month. In fact, every month we seem to be spending more and more on merchandise."

"That can't be helped. It's just guesswork on what will sell and what won't sell. OK, some of our inventory does seem to be slow moving. But don't worry, we're still making sales. Anyway, we must buy these glass kits. They're proven fast movers. Plus we buy on account."

The day on which John was expecting the stained glass kits, he got a telephone call from the wholesaler. 'Best Hobbyshop' was over its credit limit. Instead of the kits going on the account, they would only be sent on a C.O.D. basis.

"We've got the rent to pay this week," said Mary. "I guess we must let these kits go by."

"No," answered John. "We'll take only a half shipment even though we'll miss a volume discount."

That half shipment of stained glass kits sold quickly and John realized that he could have sold more. It was too late, though, for a second half order and the rent had to be paid.

"We've got a problem," announced John later that month. "I've done a rough addition of what money we've got tied up in our inventory."

He showed the figures and list of products to Mary.

"That's what we thought we'd buy for a whole year, taking into account our sales too! And it's all in kits and supplies that aren't selling fast. It doesn't seem fair that the only things we have in stock are the slow moving ones."

"I know," said John miserably. "And with this C.O.D. basis that most of our suppliers have now put us on, we can't get our hands quickly on the fast moving products."

"I have a feeling," said Mary candidly, "that our customers think we don't carry the newer or better kits any more. Our sales are getting less."

"We must do something. We're short of cash to cover our daily expenses and to buy more inventory. I hate to think what our credit rating is now."

"What has gone wrong?" wondered Mary.

The question "What has gone wrong?" can be answered by saying that the 'Best Hobbyshop' was not managing its retail inventory.

How does a retailer manage his or her inventory so as to avoid being caught in a situation like that of John and Mary Best? We shall first look at physical inventory control.

## **PHYSICAL INVENTORY CONTROL**

As we have written earlier in this chapter, retail inventory management consists of both physical control and financial control. Though we are examining physical control first, you must realize

that both forms of control are integrated components of inventory management. In other words, physical control is neither an alternative nor a first step to financial control. Physical and financial controls go hand in hand.

**Physical inventory control is a system that provides the retailer with ongoing unit records of:**

- merchandise in
- merchandise out
- merchandise in stock

In conjunction with this information, the retailer establishes the quantity minimums and maximums for the individual products and knows the time required between ordering and receiving. This tells the retailer when to order, how much, and also shows at a glance how the product is moving.

Physical inventory control is usually referred to as: **perpetual unit control** and **basics book, physical count, and visual control**.

**Perpetual unit control** ideally is a daily function which records, on a unit basis, the receipt and sale of merchandise.

Larger retailers usually have staff recording these inventory movements on a card system and transcribing the information to daily or weekly sheets for management's information. The smaller retailer normally will adapt the system of perpetual unit control to fit his or her business situation. Often, this system will be modified from that of a daily function to, depending on the particular products involved, a weekly, bi-weekly, or monthly function (or a combination of any of the four periods). While time and lack of staff may also dictate a modification, it must still be recognized that the perpetual unit control system provides the retailer with definite benefits of inventory management.

Our example below is for the smaller retailer who has combined inventory movement (recorded on cards) with the daily/weekly sheet containing reorder information.

BC 3	Stained glass kits	Reorder time 5 days			
Product Classification	Product Description	12.50	25.00	20	40
		Cost	Retail	Min	Max
Date	Reference	In	Out	Balance	
Bal. fwd.				34	
April 17			2	32	
18			1	31	
19			3	28	
22			4	24	
23			1	23	
24			2	21	
27			1	20	
28	PO 1501 +	20	3	37	
May 1	inv 411	1*	4	34	

+ purchase order number  
\* sales return, undamaged so returned to inventory

Our retailer knows the “in” from the checked supplier’s invoice and packing slip, and knows the “out” from the sales tag or invoice. The product’s minimum and maximum quantities have been established so that the retailer easily knows when to order (conditioned by the five-day delivery).

By keeping this up-to-date, our retailer is aware of (a) the quantity in stock, (b) the money tied up by this particular product ( $\text{May } 1,34 \times \$12.50$ ), (c) how the product is selling by amount and trend, (d) any problems in inventory level, and (e) when to place an order so as to be neither understocked nor overstocked.

**Basics book** is a subsidiary control to a retailer's perpetual unit control. As a retailer, you should identify what merchandise provides the bulk of your sales. These products that provide the bulk of your sales are referred to as your "basics". Your basics should be listed in a book or on a sheet and, beside each product, there should be an up-to-date inventory figure obtained from your perpetual unit control.

Your basics may account for as high as 80% of your sales. (The remaining 20% is referred to as "fringe"). This 80% of sales represents the bulk of your profits. Therefore the purpose of your basics book is to ensure that you are never out of, or very low on the merchandise that makes up the bulk of your business. The basics book should be constantly monitored for quantities in stock and to ensure that your identification of products as basics accurately reflects your customers' buying habits.

*Note: A comment should be made on "classification" and "sectionalizing" as pertains to perpetual unit control.*

Classification controls provide the function of controlling merchandise assortments by such factors as colour, size, style, price line, and brand name. Normally, the products are assigned codes (e.g. BC3) to readily identify these factors. Classification is particularly applicable to retail fashion where quick decisions on markdowns and reorders must be made on merchandise that is seasonable or one-time.

Sectionalizing refers to the method used by larger retail establishments which control their inventory by departments. A general home furnishings store may divide its merchandise into departments of appliances, draperies, bedroom furniture, living room furniture, etc. This enables the larger retailer to establish how many dollars of sales and profits each department is producing and how many dollars of inventory are invested in each department. From this, the retailer can judge the performance of each department in relation to the store's total sales and inventory investment.

**Physical count** is a count of all inventory items. Usually, two persons make the count item by item with one person counting and the other person recording the quantities on inventory sheets.

A count, at the end of your fiscal year, is required for tax purposes when preparing year-end financial statements. It is at this time that comparisons are made between book inventory records and the actuals obtained by a physical count.

To have an effective control, some retailers take a physical count twice a year or even, depending on circumstances, every quarter. This permits the retailer to catch errors more quickly in the book records. Also, a physical count more than once a year allows the retailer a better safeguard against theft, damage and the accumulation of pockets of slow moving or old merchandise.

**Visual control** means that a retailer manages his or her inventory by only looking at it instead of having a structured paperwork system. Visual control is usually practised by the small retailer whose merchandise is readily available from suppliers and whose merchandise is sorted and stored in specific sections. Also, reorder points are indicated on or close to the merchandise itself. Visual control must be constantly performed by the retailer so as to obtain maximum benefit from this system. The risk of error and of losing control can be considerable with such a system in comparison to perpetual unit control. Some retailers practise visual control in conjunction with the perpetual unit control. In this way, visual control becomes part of their “knowing the inventory” as well as being a test of their perpetual unit control system.

**Note:** The physical control in good inventory management includes the proper receiving of merchandise. Problems can easily arise if goods are not checked upon receipt. Every shipment has the potential of containing overages or shortages, damaged products, or wrong products (size, colour, type, brand). Packing slips should be checked against the actual shipment as well as against the purchase order itself.

Proper storage and handling help to prevent spoilage, loss and misplacement. Remember, loss can also be due to pilferage. When storing goods, most retailers use the first-in-first-out method. In other words, old stock goes at the front of the shelf to be sold first.

Proper coding of merchandise is also a requisite for the retailer. Merchandise must be identified correctly and must provide the retailer with product information that he or she requires. This coded information, as well as including the cost price of the product (see chapter 3), may give details such as supplier, brand name, colour, and style. This code may appear either on a sticker or a tag. Often, a retailer will have this information on the tear-off portion of a tag. This tear-off portion, removed by the retailer when the product is sold, is used for recording the "out" inventory movement. These tear-off portions can also be reorder indicators in retail businesses that must make quick purchasing decisions.

## DOLLAR MERCHANDISE PLAN

The dollar merchandise plan is the first part of your financial inventory control. This plan embraces a **merchandise budget plan**, **sales to stock ratio**, and **turnover**. It is a system that integrates planned sales to merchandise on a monthly basis and is usually prepared for a six-month period.

This dollar merchandise plan allows the retailer to properly match sufficient merchandise to anticipated sales. It takes into consideration opening monthly stocks and purchases and relates these to the planned sales. This helps the retailer to avoid being either overstocked or understocked for each month's planned sales. This plan also allows the retailer to decide how much merchandise he or she can afford which, in turn, realistically adjusts the planned sales figures.

**Merchandise budget plan** shows the relationship of sales to merchandise (stock) on a dollar basis. Before analyzing the example budget plan, some comments must be made regarding the words "retail" and "cost" as far as calculations are concerned.

The larger retailer usually bases the dollar merchandise plan on retail (selling price). Sales are at retail; therefore inventory, instead of being calculated at cost, is converted to the selling price. Retailers with a large volume and variety of merchandise will use this "retail system". Markdowns, initial markups, and other price changes must be considered in the merchandise budget plan under the retail system.



The small retailer generally operates under the cost system because of the simpler bookwork involved and because his or her inventory is usually price coded at cost. Therefore, in preparing a merchandise budget plan under the cost system, the retailer must reduce sales from retail to cost.\* (Our example of a merchandise budget plan has been done under the cost system).

In preparing the merchandise budget plan, a retailer's first step is to refer to the past year's records for the equivalent period of time to be budgeted. In our example, the period is from January to June.

Should the previous year's records not be available, the new retailer will then have to base his or her planning on the most realistic estimates possible.

The two columns entitled "Last Year" have been completed monthly by our retailer using last year's sales and last year's opening and closing stock figures.

The second step is to enter the "Planned Merchandise Sales" for each of the six months. The immediate trend of sales volume is the retailer's best single index. In other words, if the sales volume is exceeding each month its previous year's figures by 10%, then it is relatively safe to forecast a 10% increase for the ensuing six months.

Of course, a retailer's sales forecast will be conditioned by factors of economy and inflation. A retailer will also be looking for ways of improving sales volume. The last year's sales figures will be analyzed to determine what products gave the most sales and what products were slow moving. Decisions may then be made to drop certain products or push others that are proven sales makers. Also, errors may have occurred last year such as insufficient ordering, not

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\* Cost complement based on overall average as example:

Annual sales	\$200,000	100%
Cost of goods sold	<u>160,000</u>	<u>80%</u>
Gross trading profit	<u>\$ 40,000</u>	<u>20%</u>

therefore each retail sales figure is reduced to sales at cost (sales  $\times$  80%).

enough or too many discount sales, or not meeting the competition sufficiently. Higher or lower sales, therefore, may be forecasted to include corrections of these errors.

The third step is for the retailer to enter the “Planned Opening Stock” figures for each forecasted month. The factors that are considered in estimating required stock at the beginning of each month include: knowing the basic stock requirements, deciding on promotional merchandise for each month’s sales, and determining what price and product lines are to be intensified.

In determining opening stock, it must be remembered that an increase in inventory does not automatically mean an increase in sales. Also, opening stock must be in relationship to each month’s sales.

The fourth step of obtaining “Planned Purchases” is done by subtracting planned sales from opening stock, plus or minus the difference between planned opening and closing stocks. April’s calculation is as follows:

April	opening stock	\$68,750
	planned sales	<u>21,250</u>
		<u>\$47,500</u>
May	opening stock	\$75,000
		<u>47,500</u>
April	purchases	<u>\$27,500</u>

The retailer, using our merchandise budget plan, has now entered planned sales, planned opening stocks, and purchases by month. It is important to stress that the retailer, when preparing this budget, must realistically be able to say that he or she can afford the total six months’ purchases of stock. If not, and if the planned purchases must be cut back, then naturally the planned sales figures must also be cut back.

**Sales to stock ratio** is the calculation in the merchandise budget plan that shows the retailer, on a monthly basis, if there is too little or too much planned stock for the planned sales.

To arrive at the sales to stock ratio, the planned sales for the month are divided into the planned opening stock for that same month. April's calculation is as follows:

$$\begin{array}{rcl} \$68,750 & \div & \$21,250 = 3.2 \\ \text{planned} & & \text{planned} \\ \text{opening} & & \text{sales} \\ \text{stock} & & \text{sales to} \\ & & \text{stock ratio} \end{array}$$

The answer 3.2 simply means that the retailer's inventory, in the month of April, represents 3.2 times the sales. The sales to stock ratio is a comparative tool for the retailer. It permits comparisons of ratios between last year's actuals and planned and the current year's actuals and planned.

**Turnover** is another comparative tool used by retailers in financially controlling their inventory. Turnover, in our example, was calculated in two steps: finding the average planned inventory and, dividing the average planned inventory into planned sales.

The first step of finding the average inventory means, for our six-month period, adding the six opening stock figures plus the closing stock figure for the sixth month and dividing by seven. Hence:

$$\begin{array}{r} \text{six months' opening stock} \quad \$418,750 \\ \text{final closing stock} \quad \underline{50,000} \\ \hline \underline{\underline{\$468,750}} \end{array}$$

$$\frac{\$468,750}{7} = 66,964 \text{ (average inventory)}$$

The second step in calculating turnover is the addition of the planned sales for the six-month period divided by the average inventory. In our example:

$$\frac{\text{total planned sales} \quad \$133,750}{\text{average inventory} \quad 66,964} = 2.0 \text{ (planned turnover)}$$

This rate of 2.0 means that our retailer plans to turn the inventory over twice during the six-month period. This turnover rate is then compared to the previous year's rate.

Remember that the dollar merchandise plan with its merchandise budget plan, sales to stock ratio and turnover is an example only. Especially with the calculations of sales to stock ratio and arriving at the average inventory in determining turnover, there are different thoughts and methods. The purpose of your calculations is to relate sales to stock by dollars. Your ratios and percentages are comparative tools and their formulation may be conditioned by your sales patterns and cycles.

Be careful, therefore, when you compare published retail statistics to the ratios and percentages of your business. To enable you to correctly make a comparison of your business performance to the current norms in the retail industry, your figures must be calculated in a similar manner as are the published statistics.

## OPEN-TO BUY

**Open-to-buy** is the second part of your financial control. The purpose of "open-to-buy" is to provide the retailer with current information as to the dollar amounts of orders placed and the balances left to spend for purchasing merchandise. This information is shown for each month. The purchases budgeted are derived from the merchandise budget plan.

If a retailer does not follow an open-to-buy plan, inevitably there is a risk that the shop becomes overstocked. The results of being overstocked (as shown with "Best Hobbyshop") include: a smaller selection of fast moving items which means fewer sales; costly markdowns to be applied to reduce heavy inventory meaning a smaller gross trading profit; good purchases being passed up due to lack of funds; and extra money, such as a loan for purchases or working capital, having to be provided to compensate for overstocks.

In the following example, our retailer has recorded all orders as they are placed. A point to be stressed is that the order is entered on the sheet for the month in which the order will be received. Hence, we see order 1491 is to be delivered in the months of January, February and March. Either our retailer specified these shipping dates or, the availability from the supplier has meant three shipments.

# OPEN-TO-BUY WORK SHEET

Order No	Month Planned purchases Supplier	Jan		Feb.		March		April		May		June	
		Amount	Bal	Amount	Bal	Amount	Bal	Amount	Bal	Amount	Bal	Amount	Bal
		25,000		12,500		25,000		27,500		10,250		6,250	
	Dec. adj.	3,100	22,000										
1491	Blain Co.	3,000	19,000	4,000	8,500	3,000	22,000						
1492	Acme Macaroni	5,000	14,000	2,000	6,500								
1493	Hobby Crafts	2,000	12,000	2,000	4,500								
1494	Modelco Ltd	1,000	11,000										
1495	Blain Co.	4,000	7,000										
1496	Acme Macaroni	2,000	5,000	2,000	2,500	1,000	21,000						
	Jan adj.	5,000	-	(5,000)	7,500								
1497	Hobby Crafts			2,000	5,500	3,000	18,000						
1498	Blain Co.			6,000	(500)	5,000	13,000						
	Feb. adj.			500	-	500	12,500						
1499	Acme Macaroni					2,000	10,500	5,000	23,500	5,000	7,500		
1500	Modelco Ltd					3,000	7,500	3,000	14,500	5,000	2,500		
(1499)	May order cancelled									(5,000)	7,500		
1501	Blain Co.					4,000	3,500	5,000	14,500				
1502	Hobby Crafts					3,500	-	3,000	11,500				
	April adj.							11,500	-	11,500	19,000		
1503	Acme Macaroni									3,000	16,000	3,000	3,250

Some additional comments should be made pertaining to the above open-to-buy work sheet:

- the planned purchases figures entered each month are from the merchandise budget plan on page 89;
- each purchase order is identified by supplier and order number and is shown in the month in which delivery is expected;
- purchases are subtracted from each planned purchases figure or previous balance so as to obtain new balances;
- and, at the end of each month when purchases can no longer be received in that month, the balance (either overspent or underspent) is transferred as an adjustment to the following month.

Sales have a definite effect on a retailer's open-to-buy. Planned purchases relate to planned sales (see merchandise budget plan). If the actual monthly sales are not in line with the planned monthly sales, and purchases are continuing as per budget, there is a definite risk of being either overstocked if sales are down or understocked if sales are up. Therefore, the monthly open-to-buy should be adjusted accordingly, either by decreasing purchases or increasing purchases, so as to reflect the actual sales situation.

There are many variations of open-to-buy in either work sheet or summary format. Some of these can be quite sophisticated such as including monthly comparisons between statement open-to-buy (the accounting records) and the open-to-buy calculated on the basis of orders placed.

Regardless of what format of open-to-buy you adapt to your retail business, the principle demonstrated in our example will be common to all. Open-to-buy is like a cash flow statement applicable only to purchases, showing you how much money can be, or is left to be, spent monthly on purchasing inventory.

## **FACTORS AFFECTING INVENTORY**

It can be to a retailer's advantage to know the various factors, both internal and external, that affect retail inventory. This section examines a number of common factors of which the retailer, who practises good inventory management, is aware.

**Shrinkage** is a general term used to describe the difference between book inventory and the actual physical inventory. Shrinkage is a result of two causes: physical discrepancies and paper errors.

Physical discrepancies can be due to loss, theft, shoplifting, mishandling, spoilage or incorrect shipments by the supplier. Paper errors can include: failure to properly check packing slips against actual receipt of merchandise; failure to record goods received or sold; measuring incorrectly (e.g. yardage); incorrect identification of products both by receiving and selling departments; mistakes in inventory counting and recording; and, mistakes in recording inter-department or branch store inventory movements.

**Price lining** is when a single retail price is substituted for a variety of prices within a narrow range. This is based on the belief that customers buy within price ranges or limits. These ranges (price lines) will identify the grade (quality) of product. The retailer will select the grade based on considerations of clientele, shop image and sales.

Price lining affects inventory because it usually means the retailer will carry fewer items and larger stocks of each item. Of course, the line that generates the largest volume of sales will be stocked in a greater depth than the grades with fewer sales.

**Markdowns** are the difference between the original selling price of products and the final selling price. How successful they are in moving merchandise affects a retailer's inventory. Markdowns may be planned as a regular merchandising feature such as a spring or end-of-season or semi-annual sale. Markdowns may also be a necessity resulting from a too high initial markup, customer resistance, seasonal conditions, competition, and the appearance of new or lower priced products. Also, the risk of physical deterioration or style change can be a dictate for a markdown.

**Turnover**, as explained previously, has a major effect on inventory. How often the inventory turns over will influence the decisions of what merchandise to purchase and what inventory to mark down.

The new retailer, realizing that poor turnover is often caused by excessive purchase of not readily saleable goods, may be tempted to

keep the inventory small. The risk, then, is one of being understocked with the result of merchandise assortments being incomplete which means loss of sales. Also there is the risk that, with a small inventory, the shop could repeatedly be out of basics; this again will result in loss of sales. Too little inventory can be just as bad as being overstocked.

**Open-to-buy** will directly affect inventory through purchases. Should there be an overspending in one month, good retail inventory management calls for a cutback on purchases in the following months so as to remain in line with the budget. An underspending will, of course, mean the opposite: extra money available for the next months' purchases. Likewise, the relationship of actual sales, over or under, to planned sales will be reflected in the open-to-buy by adjustments to purchases.

The open-to-buy system, by showing the retailer exactly how much money is available to spend on merchandise in any given month, allows the retailer to know if he or she can make special inventory purchases. These special purchases may be discounted merchandise from the supplier, new products suddenly on the market, or additional purchases of products that are proving to be popular with the consumer.

**Business conditions** are, collectively, a general factor affecting inventory. The conditions may arise from within the business, for example: limited storage space; cutback in purchasing because of cash allocation to other aspects of business such as capital expenditures; policies; staff competence levels; and, poor merchandising.

Unlike the internal conditions which can usually be controlled by the retailer, external conditions are usually what the retailer can do little to change. Most external conditions will be reflected in sales and turnover. A depressed economy and high unemployment, regionally or generally, will mean fewer sales and a slower turnover. Conversely, when the economy is on the upswing sales will be up and turnover will be quicker. A retailer, who depends on imports for merchandise, may be suddenly faced with the non-availability of certain products or price increases that prohibit retail competitiveness. Suppliers may short ship or put an expected shipment on

back order. Trend and style shifts on the part of the consumer are other external business conditions.

All of these internal and external conditions can affect a retailer's inventory. Good retail management demonstrated in planning, purchases, markdowns and promotion will help to compensate adverse business conditions.

## **DANGER SIGNALS IN INVENTORY MANAGEMENT**

When a retailer claims to be practising good inventory management, this means not only having physical and financial controls, but also knowing the system's danger signals. These danger signals, or indicators, warn the retailer of developing problems. Without inventory management, these problems are often caught later when they have seriously affected the total business operations.

**The major danger signals common to most retail establishments are:**

- sales slipping — budgeted sales not being met by actual sales;
- actual sales to stock ratio on merchandise budget plan compared to planned sales to stock ratio indicates either overstocked or understocked position;
- actual turnover rate not as planned or does not compare to last year's actuals;
- perpetual unit control indicates slowdown in merchandise movement;
- open-to-buy sheet shows purchase slowdown or a constant overbuy;
- visual control shows large stock position;
- dollar amount of markdowns increasing;
- and, gross trading profit slipping — indicated by both percentage and dollar figure.

When any of these danger signals appear, a retailer will look at several aspects of inventory to determine the cause and to find the correction.

**Inventory assortment** is the first aspect of inventory at which a retailer looks. A number of questions will be asked: Am I carrying the right colour, style and type of product in sufficient quantities? Are the products that I term my "basics", which give me most of my sales, still valid as such? Are my basics in sufficient quantities or am I carrying too many fringe products? Are the products themselves old or are they fresh? Am I selling in the wrong quantities like selling by the unit instead of by the box?

**Purchasing** is the second aspect to be checked. Are stocks too low because quantities on the perpetual unit control are allowed to drop below the specified minimums? If stocks are too high, is it because orders are being placed before they are necessary? Is the reorder time, which accounts for the period between ordering and receiving, correct? Am I buying from too many sources thus resulting in many small shipments? Is my timing wrong and am I stopping my purchasing too early or too late on seasonable or trendy products?

**Price lining** should also be checked. What price ranges are selling? Is there too high an inventory of slow moving price lines? (The test of a good price line is the speed at which it turns over).

**Inventory related aspects** to be checked include merchandise handling and recording, initial markups, and markdowns. Are all purchases, shipments received, and sales being correctly recorded? Are spoilage and theft problems? Are the initial markups realistic and are they built on current costs? Are markdowns being taken indiscriminately and how do they compare to last year?

It should be noted that a new retailer, when faced with an overstocked situation, may decide to drastically curtail all purchases. Often this compounds the situation of poor turnover. A sensible way to correct this situation is to determine what particular products are causing the turnover to slow down. Once these products have been identified, options of promotion and markdowns may be taken so as to move them. Even when striving to push slow moving products out of stock, a retailer will continue to replenish fast moving basics and to bring in new items.

## GLOSSARY OF INVENTORY MANAGEMENT TERMS

Throughout this chapter, we have used a number of terms applicable to your inventory management. This section lists most of the terms (along with brief explanations) found in this chapter.

### **Basics book:**

Products that generate most of the total sales. An up-to-date listing of the products identified as basics.

### **Classification:**

Perpetual unit control system of merchandise by colour, size, style, price line, and brand name. Applicable to retail fashion or similar seasonal or one-time products.

### **Daily/weekly sheets:**

Transcribed physical inventory movements. Part of perpetual unit control. Contains reorder information.

### **Depth:**

Term used to express quantity of a product in inventory.

### **Dollar merchandise plan:**

Financial control of inventory. Includes merchandise budget plan, monthly sales to stock ratio, and turnover.

### **Fringe:**

Products that generate a small percentage of sales. Opposite to basics.

### **Inventory:**

Merchandise or stock held for sale.

#### **average inventory:**

Average amount of inventory for a specific period of time (expressed by months).

#### **closing inventory:**

Merchandise on hand at the end of a given period of time after purchases and sales are taken into consideration.

#### **opening inventory:**

Merchandise on hand at the beginning of a period of time.

**Markdown:**

A decrease in the selling price.

**Markup:**

Difference between landed cost of a product and its selling (retail) price.

**Merchandise:**

Collective reference to products.

**Merchandise budget plan:**

A budget that shows the relationship of sales to stock on a dollar basis. Uses calculations of opening stock, purchases, closing stock and sales. Incorporates sales to stock ratio and turnover.

**Open-to-buy:**

A system that provides retailer with information as to dollar amounts of orders placed and balances left to spend for purchasing merchandise.

**Overstocked:**

Refers to inventory when the level, either by quantity or dollar value, is in excess of what is deemed ideal.

**Perpetual unit control:**

The recording on a unit basis of the receipt and sale of merchandise.

**Physical count:**

A count of all inventory items. Compares actual quantity of inventory with book inventory records. Required at year-end for tax purposes.

**Price lining:**

A single retail price replaces a variety of prices within a narrow range. Grades of the same product differentiated by price ranges.

**Quantity minimums and maximums:**

Reorder information in perpetual unit control system. Specified on unit cards or daily/weekly sheets.

**Reorder point:**

Indicator by quantity of when product should be ordered. Takes into consideration time lag of order date to delivery.

**Sales to stock ratio:**

Calculation that shows to the retailer the relationship of sales to stock. Usually done on a monthly basis.

**Sectionalizing:**

Control of inventory by departments or sections. Used to compare departments or sections to each other and total store performance. More often used by larger retailers.

**Shrinkage:**

The difference between book inventory and actual physical inventory.

**Spoilage:**

Merchandise lost through damage or decay. Differs from theft or disappearance.

**Stock:**

Merchandise or, sometimes, synonymous with "inventory".

**Turnover:**

Ratio that shows to the retailer how often in a given period of time the dollar value of inventory will be, in theory, completely replaced.

**Understocked:**

Refers to inventory when the level, either by quantity or dollar value, is less than what is deemed ideal.

**Visual control:**

Control of inventory by looking. Part of "knowing your inventory" without structured paperwork. Reorder points indicated on or near merchandise. Used by small retailers.

## CONCLUSION

Your retail inventory, probably your largest investment or asset, represents your future income. At the same time, it can be or is the cause of your accounts payable; a risk requiring insurance coverage; a direct cost affecting your profits; an indirect cost as interest expense if you are financing your inventory; and, a physical existence requiring storage, handling and display. In non-accounting terms, your retail inventory is both an "asset" and a "liability" to you.

Good inventory management will help you to ensure that your inventory really is an "asset" and not a "liability".



## 5. ATTRACTING AND KEEPING YOUR RETAIL CUSTOMERS

*"You have to promote and advertise to survive today. It is part of the selling package. Not using promotion and advertising is like having two salespeople and only using one." — CASE counsellor*

INTRODUCTION .....	106
CONSUMER PSYCHOLOGY .....	106
KNOWING YOUR CUSTOMERS .....	108
PROMOTION .....	113
ADVERTISING .....	123
DISCOUNT SALES .....	132
CONCLUSION .....	133

## INTRODUCTION

As a retailer, you need customers. The more customers you have, the more successful you should be. How, therefore, do you attract potential customers into your shop and how do you keep them once they have become your customers?

The answer is that you must promote and advertise your business. Promotion and advertising are two important tools of good retail management. As a rule, shops that do not promote and advertise simply don't do as well as those that do promote and advertise.

This chapter is a general introduction to the concepts of retail promotion and advertising. It looks at the elements of consumer psychology (why people buy), customer profiles, promotion, advertising, and discount sales. As well, throughout the text are some practical do's and don'ts of customer relations.

## CONSUMER PSYCHOLOGY

Before examining the concepts of promotion and advertising, we should look at the elements of consumer psychology. As a retailer, it can be helpful for you to understand why people buy and to relate this information to your own shop and products. Consumer psychology is the basis upon which promotion and advertising are built.

Why do people buy? In answering this question, the key word is **need**. People buy a product because they believe they **need** it. Therefore, to understand consumer psychology, we must try to understand the word **need** and how it is determined.

**Consumer needs can be categorized under three general headings:**

- basic needs
- luxury needs
- impulse needs

**Basic needs** are those wants required for physical survival. These wants include nourishment, shelter, clothing, protection, and

rest. Normally, these wants are satisfied by the consumer before other purchases are made.

**Luxury needs** are those wants beyond basic needs. In other words, a person's physical survival is not affected by the possession or lack of a particular product. Luxury items are usually purchased after basic needs are satisfied.

**Impulse needs** are needs created suddenly because a particular product is priced right, is attractive and has appeal, and indicates a use for the consumer.

Of course, all three categories are conditioned by psychological factors or desires dictated both by society and the personality of the individual. These ever changing, yet interrelated desires of security, status, recognition, and satisfaction are what determines need either consciously or subconsciously on the part of the consumer.

Reflecting the complexity of society and the consumer, these psychological desires are often disguised by other buying motives. Let us take any product in the three categories and compare what people would say is their reason for purchasing to the probable psychological reason.

Our example could be clothing which is a basic need:

<b>buying motives</b>	<b>psychological desires</b>
"latest style"	recognition
"top quality"	status
"good price"	security
"comfortable"	satisfaction

Naturally, many of the psychological desires are interchangeable. Buying top quality can not only give the customer a sense of status, but can also fulfill the desires of recognition and satisfaction.

To further illustrate consumer psychology and to help prove its existence to yourself, think back to the last major purchase you made as a customer. Analyze why you bought it. Look at why you needed it and relate the reason to your buying motive and to your psychological desire.

The purpose of this section is to make you aware, as are most retailers, of the reasons why people buy. Why people buy and the

fact that the motivation to buy is often hidden, should be kept in mind when planning your shop's promotion and advertising. This knowledge will help you have a better understanding of your customers.

## KNOWING YOUR CUSTOMERS

With promotion and especially advertising, to have an effective program, you must be able to answer the question: who are my customers?

It makes good retail sense to know who your existing clientele is and who your potential customers are. Promotion and advertising cost money, so you want to be sure that you will have results in the form of sales. Therefore, you want to direct your efforts to the right people and only the right people. These people must have money to spend and your shop and products must fulfill their needs.

### I. What determines who will be your customers?

Before analyzing your customers, you should know why these people are customers in the first place. What makes people become customers? We know they must have needs, but what makes people become *your* customers?

The answer is to be found through your **product, price, market, location** and **competition**. While we will examine each factor in turn, it must be remembered that all five factors directly affect each other.

**Product**, in other words what you are selling, has a major effect in determining your customers. You may be carrying specialized product lines which appeal to a small number of people or, conversely, general products with popular appeal. (A kite shop and a variety store are contrasting examples of a specialty shop and a general retailer).

The type of product or product line also affects who your customers are. Books can be considered as a general product, but if the books carried are limited to specific topics such as the occult, business, or art, you cannot expect the general public as customers.

Quality of product is an important conditioner as to customers. A men's shop selling sports shirts and working clothes will have a different type of customer to the shop selling custom-made business suits. Yet, both shops are men's clothing stores. Again, using the example of the men's clothing shop, we can find distinct differences between a shop carrying and advertising top brand names and one that sells just the generic product, men's suits. The customers of these two stores will, more than likely, be different people.

**Price**, usually, goes hand in hand with product. Your price lines will relate to the quality of product you are carrying and, together, will dictate your type of customer. A furniture store selling the low to middle price ranges of bedroom suites will have different customers compared to the shop carrying only the top price lines.

Your pricing policy may be such that, though you know your prices are slightly higher than other retailers', your quality of service makes up the difference. Customers, who accept your conditions, will not be the same as those who are looking for bargains. This holds true in the opposite manner. You may be able to buy your products in large quantities or negotiate good deals with the wholesalers and, as a result, undercut the regular prices. The bargain shopper, whose emphasis is on price, will then be your customer.

**Market**, meaning demand, is the number of people wanting what you are selling. Are there many people who need your product or is the number limited? If the number is limited, is it a special type of person who will be your customer? Your market may be one that is limited to specific seasons (e.g. ski shop). This, too, will have an effect as to the type of customers you will have.

How large a market you have probably bears a direct relationship to what needs you satisfy for people. As we discussed previously, the key words describing needs are: basic, luxury, and impulse. Generally, a retailer will have a larger market if, first, he or she is selling basics (especially repetitive basics) and, second, luxury items than if selling only impulse items. There can be a difference in the type of customer you have depending on whether your market is to fulfill basic needs or luxury and impulse needs.

**Location**, like the factor of product, is a major determinant of your customers. In fact, location can easily nullify the customer

effect of product. For example, you may be specializing in high class women's fashion which means your customers should be the middle and upper income group. Yet, if your location is in a working class district or in an area of urban decay, chances are that, unless you have a fantastic reputation that warrants customers travelling to you, your clientele may be non-existent.

Where your shop is located, therefore, has a paramount effect on who your customers are. A downtown business district location, with heavy customer traffic, probably means that your customers are the general public. Office workers on lunch hours may be limited to quick purchases and, unless there is inducement in the city core to remain in the evenings or to come in on Saturdays, they may not be customers making major purchases. Unfortunately, few urban centres today are able to combine residences and businesses downtown.

The alternate locations, therefore, become major and secondary shopping centres. Usually, major shopping centres have been established as a result of considerable market research both to the present and future (new or growing suburbs). Most of the shopping centres' clientele is drawn from the immediate area. Because shopping centres serve suburbs of varying affluence, your choice of centre will decide the type of customer you will have.

A neighbourhood location means you are limiting your business to a specific group of people. The neighbourhood you have chosen with the people to be found in it will certainly dictate who you will have as customers.

**Competition**, certainly if successful, will affect who you have as customers. A larger retailer who buys in large quantities may be your competitor. If you can't compete with the lower prices that the competitor offers, maybe you can offer a better service or a higher quality of product. This naturally will determine who are your customers. The opposite, of course, holds true. Overheads lower than those of the big stores may possibly mean that you can sell at a lower price and get the bargain shoppers.

Your competitors and their share of the market, especially if they are long established and you are new, will dictate what customers you have. A competitor, whose clientele is the middle and

upper income groups, may force you to find your customers amongst the less affluent. A discount outlet, as competition, could mean that you limit yourself to selling only the very top quality which, of course, means a certain type of customers.

To conclude part 1 of this section, it must be stressed that you relate your product to the type of customer you want and who will come into your shop. Your location, in turn, must be related to the product and to your customer.

## **II. What do you find out about your customer?**

You find out as much as you can about your existing and potential customers. The sort of questions you should be asking are as follows:

- What type of people need my products?
- Who are, or will be, my customers?
- Where do these people live and how far away are they from my store?
- What are their ages?
- What are their lifestyles?
- What are their average incomes?
- What are their buying habits?

Let us look at the questions to see what the answers can tell the retailer. Knowing the type of people who need your products is a major step in targeting your customers. If, for example, you are selling moderately priced children's wear, you probably have identified your type of customer as middle income young families. No longer, therefore, are you looking just for customers. You are now looking for a specific type.

The answer to who are your customers can be quite surprising. It may be that you believe you have a certain type of customer because of your product, yet upon analysis, the customer type that emerges may be quite different. As a retailer of moderately priced children's wear in our example, you may have correctly identified the type of customer; but the people coming into your store may not fit the type. The customers could instead be less affluent; yet, because of your location, they buy at your shop. In this case, maybe

your sales volume would be greater if you carried some lower price lines.

The new retailer without existing customers must ensure that the type of customer he or she expects will be the type that comes into the shop. The study of the location and the customers within the area will help confirm who the actual customers will be.

Knowing where your existing and potential customers live and the distance to them from your shop's location determines your geographic area (or size of market). Customers usually go to the most convenient and closest place. Or, put the other way, your location is where you will find your customers.

Because your location determines your customers, it should again be pointed out that you must be sure that your product relates to these people. If not, it may well be that you are in the wrong location. A simple example is a garden equipment and seed shop located in a downtown area. This retailer's location, which dictates who the customers are, cancels out the need for the product.

The importance of knowing your customer's location will be stressed further when we examine advertising. You don't want to waste your advertising dollars and efforts on an audience whose location prohibits them from being your customers.

Age, lifestyle, average income, and buying habits are information that will go a long way to complete the picture of your customers. This information, again, allows you to determine whether or not there is a market for your product. Finding out that the people served by your location have an average age of over 40, are affluent, have a materialistic lifestyle symbolizing success, will probably mean that you will reconsider the location of your kite store in this area.

Knowledge of who constitute your customers, while allowing you to decide such things as products and price lines, is of direct assistance in planning your advertising program. This customer knowledge gives you ideas of approaches, methods, and content for your advertising.

The immediate question in reference to this section of the chapter is: Where do I get the information on my existing or potential customers?

For existing customers, an excellent source of information is a customer file. Customer files are usually possible with the specialty or small shop that has an established clientele. These records, compiled by the sales staff, keep track of names, addresses, purchases and sometimes preferences of the customers. Occasionally, additional notes pertaining to the customer will be included in the file.

Other sources of information on existing customers can be the normal records that a business keeps. These can include order slips, invoices, charge accounts or similar. Observation of customers in the shop and comments from the sales staff can also be a customer information source.

For potential customers, as well as for existing customers, there are a number of information avenues open to you. These include:

- your own knowledge of the area and that of others;
- visiting shops;
- Chambers of commerce and local business associations;
- Statistics Canada;
- Government Departments;
- municipal government (City Hall);
- advertising agencies and direct mail firms;
- trade associations and retail associations;
- and, suppliers.

All of the above sources are discussed in detail in chapter 1.

## PROMOTION

We have defined retail promotion as being the constant presentation of your business to the consumer. This is in contrast to retail advertising, covered in the next section, which we define as being the special, extra generator of sales through the use of external means.

### **Promotion, which is part of your selling package, is:**

- the exterior of your shop;
- the interior of your shop;
- and, your sales staff.

All three aspects are interrelated and, together, represent your business. If your advertising is polished and you project a good image of your business, this image must be supported by your promotion. A negative reaction from the consumer to your shop can easily materialize if he or she feels duped by a false advertised image.

**The exterior of your shop** is usually the first aspect of your business that the consumer will see. As the saying goes, first impressions are lasting impressions. Realizing this, you therefore want to make the right impression compatible with your product and clientele.

Your shop must have a **sign**. While this is an obvious statement, certain considerations must be given to the sign's appearance. The purpose of your sign is to identify your shop by name and to give some indication of the products you are selling. A professional looking sign is one that effectively communicates without being cluttered by too much information.

It is important that your sign conforms to the image of your shop. A top quality furrier, for example, will more than likely not have a gaudy, high visual impact sign. Instead, one would expect a simple sign with the company's name and the words "top quality furs" or similar. Simplicity, today, is the key word for signs. The trend is definitely away from the flashing neon signs.

Your sign should be kept in scale to the size of your shop so as to give a pleasant, balanced appearance. Yet, viewing distance must also be considered. If your location is some distance away from the normal consumer traffic, your sign will have to be made more prominent to compensate for this handicap. If your sign is floodlit at dusk and at night, you must avoid hot spots of light that obliterate the wording. Make sure that your floodlights are operative. The same holds true if your sign is electric. A malfunctioning or inoperative sign gives a poor impression.

Limitations on signs do exist. If your shop is located in a mall, you may find that the mall owners have set certain standards for signs. This can mean your sign will lose, to a certain degree, its individual prominence. Some municipalities have by-laws that set conformity as to size and format of sign, so check before you buy a sign.

A **shop window** is a retailer's showcase to the world. Your window, therefore, is going to tell the consumer a story; a visual description either of the type and quality of products you have for sale or of a particular product or product line that you are featuring.

The first comment to make concerning shop windows is that they should be clean. No one likes looking through dirty, clouded glass. While the outside of the glass should ideally be washed daily, do not forget to regularly clean the inside of the window as well. With the exception of stickers when you are having a discount sale, or advertising a "special", the recommendation is that the windows be clear. Clutter distracts from the purpose of glass: to see through.

Clutter is also a word that is not applicable to the **window display** itself. Avoid careless displays. To the passerby, your shop window is your store. Treat your window as a stage with a foreground, back and wings. And, as in a stage play, the centre foreground is where the attention is directed. The back and wings are supportive functions. Keep this comparison in mind when you display merchandise in your shop window.

Avoid dark backgrounds in the window as this can cut the viewing depth for most types of window displays. On overcast days and in the evenings, the lights for the window must be switched on. Reflectoin on the window glass is always a problem, so be careful in your placement of interior lights. Spotlights, especially, must be aimed downwards.

What can we say about the display itself? It must be attractive and it must be interesting. The display should be logical, meaning that there must be a common denominator linking the different displayed products. Put a description and a price tag beside each product. Passersby want to know what they are looking at. If the price is not there, how many people really come in and ask, although some retailers do advocate that the lack of a price tag will induce people to come into the shop to ask.

Rotate the display. Do not have the same products in the shop window week after week. You attract the consumer with something new, not with what he or she has seen repeatedly. Depending on what you have in stock, your window display should be changed every seven to ten days. Use themes for your displays be it seasons,

festive occasions (Back-to-School, Halloween, Christmas, St. Patrick's Day etc.) or special effects such as using antiques, piles of newspapers, hay, ceramic animals, tires, or just about anything that can relate to your products. Take care that the themes conform to your image. Use your window to feature a new product or a product whose sales need a boost. People remember window displays either consciously or subconsciously as a reason to return to your shop. People do like to window shop. Take advantage of this, it is part of your promotion.

**Doors** should be visible as doors. Their purpose is not only to enter through but also to allow people to see into your shop. Your door is part of your promotion. Keep the door clean and, possibly with the exception of the words "push" or "enter" and credit card symbols, clear.

The **facade** of the shop should show that you are a retailing establishment and should indicate the quality. This is especially worth noting if you are establishing your business in a location that previously was not a retail shop or was a retail store of a different kind to yours. The façade must be compatible with your products. And, if you are installing a new shop window, make sure it is at eye level.

The immediate area around your shop should be clean. Refuse, dirt, or slush in the winter, that are outside your store are, according to the customers and passersby, yours and not the city hall's.

A final comment concerning the exterior of your shop: look at it once a day from the outside to see how a customer views it.

**The interior of your shop** is very important. Until your sales staff and products convert a consumer into a customer, the atmosphere of your shop's interior is what keeps the consumer interested. As with the exterior of your shop, the interior must be compatible with your image and products.

**Floor space** and how you use it have a major effect on your interior. Regardless of how much square footage you have available, you must put it to the best advantage. The amount of space available will, naturally, set limits on what you can do. It is important, therefore, to match the size of your store not only to your

budget, but also to your type of retail business and to your share of the market. Having a lot of floor space to display a large amount of inventory does not necessarily mean that you will automatically have a high volume of sales.

A number of points can be made regarding your use of floor space. Your layout will be determined mainly by your type of retail business and the degree to which you offer customer self-service. A supermarket and a dress shop will have different layouts not only because of product but also because of the need to serve the customers. Stockrooms, workrooms, and fitting-rooms if required will dictate your type of store layout. The number of doors and cash registers and their locations are other factors to be considered. It must be remembered that a good layout or use of floor space is one that makes the customer feel comfortable and which effectively displays your merchandise.

The purpose of **aisles** is to lead the consumer into your shop and all around the shop. Accordingly, you should have a lead aisle from your front door that takes the consumer into your shop. Secondary aisles are there to lead the person to the other sections of your shop. Aisles should be as wide as is economically possible so that shoppers are not crowded together and can pass without colliding. Aisles must be kept clear and clean.

Aisles should be planned in conjunction with your displays. The key words in this type of planning are "traffic patterns". Aisles must be laid out with the thought of how you want shoppers to circulate in your shop. Where you plan to place your merchandise decides where your aisles will be.

**Fixtures** must complement the decor of your shop's interior. A note of caution, though, must be given concerning fixtures. If you have a limited amount of money to spend, remember that you are not selling fixtures. Do not sacrifice your inventory purchases by buying or leasing overly expensive fixtures.

Fixtures should be clean and current; although old fixtures, if they are in good repair and have an antique style, can add atmosphere to the proper type of retail shop.

Fixtures for displaying merchandise include stands, shelves, counters, bins, racks and gondolas. Your choice of display fixtures or combination of fixtures depends, to a great extent, on the products you are selling. For advice in this area, you can consult trade magazines, professional layout artists, interior designers and those companies selling fixtures. Visiting other retailers may also give you ideas.

Interior **effects** are such things as temperature, lights, colours, mirrors and music to which, subconsciously, the consumer reacts.

The temperature in your shop should be moderate so as to ensure that shoppers feel comfortable. Especially in winter, when customers are warmly clad, you should avoid excessive heating. Not only is this a needless expense but, if oppressive, can induce customers to leave the premises as soon as possible. Your lighting should also be moderate yet sufficient so that your merchandise is clearly visible and not lost in shadows or darkness. Excessive lighting can, to some people, be a discomfort and can also cause heat buildup in your shop. In the summer, this can put a strain on your air-conditioning and, as a result, can cost you money needlessly.

It has been proven that colour helps set the buying mood. Background shades (on walls, carpeting, ceilings) should not visually overpower your merchandise. Avoid bold, aggressive colours. Have your colours blend in as part of the total picture. Colour is there only as a backdrop to your merchandise. It is suggested that, for high priced merchandise, you use any of these colours for your background: blues, greens, greys, and blacks. For low priced merchandise that needs a boost to look attractive use yellows, oranges and whites as background colours.

Mirrors should be used with discretion. While they can make a small interior appear larger, they can also be very distracting to the shopper. The purpose of a mirror is to reflect and, as such, usually is left to the fashion trade.

Music is another effect that requires careful consideration. Your choice of music may not be to everyone's liking. If you are using a radio, advertising and voices will be a distraction. Recorded music and the installation of the sound equipment are usually fairly expensive. In certain areas of your shop, the music will be louder than in

others because of the placement of the speakers. Music can certainly help set the mood, but its inherent problems have meant that store music is declining in popularity both with the retailer and the shopper.

How you **display** your merchandise is largely determined by the type of product you are selling. Certain rules, though, apply to all merchandise displays.

Do not overcrowd your display. If you put too much merchandise out you will confuse the shopper. This confusion will not only mean that the shopper does not “see” certain products but also that the shopper will have a tendency to become negative. It is also easier for the consumer to make a buying decision between one, two or three products than among half a dozen. The trick is to make each product stand out. Conversely, your shelves should not be half empty so that you appear to be in the last stages of going out of business.

Shoppers are also looking for a logical layout of merchandise. For example, a hardware store should have all its paints in one section along with brushes and related painting materials. This will show the shopper your complete stock types and can induce him or her to buy related products. Even very small shops should group their merchandise in distinct sections. Customers also become familiar with merchandise locations and irritation can easily materialize if they cannot find certain products in expected locations. Be careful then when making changes, you do not want to play hide and seek with your customers.

There must be a reason in your display. Arrange your display according to the most significant category, be it colour, style, size, or price. If you are pushing a special colour, then centre that colour in your display and have more items of that particular colour than of other colours. Especially with apparel and shoes, care must be taken in the rationale of your groupings. Customers should not have to hunt.

To answer the question of what quantities to set out for each category in your displays, you must refer to your sales. The colour, style, size or price that sells the most should be available in the largest quantity. Keep an eye on your shelves and restock.

Earlier, we stated that aisles are planned in conjunction with your displays. Do not forget that certain aisles have heavier traffic than others. The counters on each side of your lead aisle are generally more effective for catching the customers' attention than are the secondary aisles. The same is true of the counters at the immediate ends of aisles. These locations can be good spots for special displays of feature goods, clearances and loss leaders. The immediate area of your cash register is often an impulse buying area especially for small items. You may also wish to establish a certain section of your shop for weekly "specials" so that shoppers become familiar with that location when looking for bargains.

When laying out your merchandise, be conscious of the risks of shoplifting. Expensive and small items should be kept, if possible, away from areas of general handling or placed in a location where sales staff can keep the merchandise under observation. Merchandise displayed at waist level has a greater risk of pilferage than merchandise at chest or eye level.

In conjunction with merchandise displays, something should be said about display signs. Some of the suggestions will sound similar to those pertaining to the merchandise display itself.

Your **display signs** must be neatly lettered and have a professional appearance. A poor appearance distracts from the message. You must avoid too many signs. Too many signs will mean the individual messages will be lost and the shopper may become confused.

There must be a reason for the sign. The sign must give compact, yet descriptive, information. Price, special aspect, or simply what the item is, should be the imparted information. Signs may be drawing attention not only to one particular product, but also to a whole product line or lines. In this case, the signs may be as general as "Back-to-School", "End-of-Season Clearance", "New Arrivals" or "Imported Leather Coats", and "This Week's Best-sellers!" Signs are often needed to identify department or groupings ("Linens", "Books", "Cosmetics", etc.). Sometimes, if a retailer has a large floor area, signs can be helpful in identifying the locations of the cash registers.

If you are having a discount sale (discussed further in this chapter), your signs, by their very existence, should identify the location in your shop of the sale merchandise, what merchandise is on sale, and an indication of what the saving is ("30% off", or "\$74.99 reduced to \$49.99").

The colours of your signs are important. Visual impact combinations are black or red letters on white. Sale signs are often red letters on a yellow background. Tinted backgrounds and matching colour contrasts such as dark blue on light blue can be expensive.

**Your sales staff** is crucial to your retail business. Salesclerks can make or break a shop. To the shopper, the sales staff is your business personified. An incompetent, indifferent, or rude clerk can easily eradicate the image that you have built up through advertising, promotion and your product.

The people whom you select to become your sales staff must, first, have a liking for the retail business and, second, be people-oriented. To be people-oriented, or at ease with the public, is mandatory for your sales personnel. The next criterion for your sales staff is that they be knowledgeable of the products you are selling. This should be learnt from either yourself, as the owner, or from the manufacturer's representative. Knowing what the product is, its features, and being able to answer why the product carries the price it does, will go a long way in helping to close a sale.

What should a salesclerk be? Your salesclerk should be pleasant to the customers at all times. A moody salesperson does not belong in a retail shop. Your clerk should be interested in the customer and the customer must realize it by the clerk's attentiveness. A salesperson must be courteous regardless of how abrupt a customer may be. A salesclerk must also look professional, which usually simply means a tidy appearance.

What does a salesclerk do? A salesclerk is there to sell. Selling does not mean that the clerk pounces on the shopper as soon as he or she enters the shop. While the retail trend is moving towards self-service, the majority of people are looking, not for someone to take their purchase, but for someone to give them assistance and advice. A salesclerk should be able to explain the product to shoppers, and be able to answer questions, especially when product

comparisons are being made. A salesclerk must help the shopper in making purchase decisions. A salesclerk must also make alternate product suggestions especially if the requested product is not in stock. A salesclerk should suggest additional related purchases or try and guide a customer from a low-priced item to a higher-priced one.

Your staff must foster the aura of honesty and fairness. Salesclerks should always keep busy such as with "housekeeping" tasks of arranging merchandise; yet, at the same time, be aware of customers and be nearby to offer assistance. In addition to keeping a customer file (previously discussed), they should remember the names of their customers. Courtesy and circumstances will dictate whether or not the customers are called by their first or last names.

If you use your staff to ticket and price merchandise or to prepare merchandise for the floor, remember that, if possible, this should be done in the stockroom. The selling area is just what it is, a selling area. Another point concerning staff is that you communicate with them. Have regular meetings. Get advice and suggestions. Ask why they think certain products are not moving. You may be surprised to find that they have the answers.

To get the most out of your staff, show appreciation and recognize their efforts. Offer monetary and fringe inducements to sell more. Have sales competitions. Let your staff know that, with you, they are part of a team. Build loyalty. A happy and productive staff helps ensure a good customer-shop relationship which inevitably reveals itself as sales. Quality of service helps ensure that customers return to your shop.

To conclude this section on promotion, it must again be stressed that the image you create through advertising must be supported not only by your merchandise but also by: the exterior of your shop, the interior of your shop, and your sales staff. Do not disappoint the consumer.

# ADVERTISING

With few exceptions, retailers should advertise and they should advertise regularly. With today's competition and the large number of retail shops from which the consumers can choose to make their purchases, a retailer can no longer wait in his or her store for shoppers to come in. Effective advertising is an integral part of successful retailing.

**Advertising is "mass" paid communication. The purpose of this communication is to:**

- inform the consumer of the existence of your business and the products that you sell ;
- persuade the consumer that he or she needs a certain product now and should buy this product from your shop ;
- and, remind the consumer of your shop and the good service, products, and prices that he or she has found there.

The above can be simply expressed as attracting customers to build up your sales volume.

## I. Planning your advertising

Most successful retailers do not let their advertising "just happen". Effective advertising is part of good retail management and, as such, should be planned ahead. An advertising program, ideally prepared six months to a year in advance, answers three important questions: **Why am I advertising? When do I advertise? How much will I spend?**

**Why am I advertising?** The answer to this question goes beyond the defined purpose of attracting customers. This is a question of what do you emphasize in your advertising. If you are a new retailer, you will probably wish to put your advertising emphasis on your existence by pushing your name, location, and type of products. If you are an established retailer, your objective may be to emphasize the good reputation you have earned for service over the years. In either case, emphasis at times will be put on the product or product line. Emphasis will be on the product

because either the product is new on the market, must be capitalized on because of its seasonal nature, or is slow-moving stock and needs to be moved by a special discount sale.

**When do I advertise?** The timing of your advertising is mainly conditioned by your products. Your products may fulfill consumer needs at certain times of the year. If you have a sports equipment shop, you will advertise your skis and skates at the beginning of Winter and advertise your bicycles in the Spring and early Summer. Maybe your product can be advertised in conjunction with a festive season or holiday such as St. Valentine's Day or Mother's Day. The Christmas season, obviously, will require a lot of advertising. You may plan regular clearance sales; for example, a January clearance, Summer clearance, Back-to-School sale. If you have identified the high selling cycles for your products, these may be the times when you will advertise heavily so as to capture your full share of the market.

When planning your advertising program, there must be flexibility for special advertising requirements such as a tie-in with a manufacturer's national advertising of a brand name product, or your discovery during the year that some of your products are slow moving and must be cleared before becoming dead stock.

If your emphasis is more on informing or reminding the consumer of your existence than on featuring certain products, your timing may be more flexible. When to place your advertising will probably be dictated by considerations of traditional and anticipated business activities (holidays, seasons, mall promotions, manufacturers' national product advertising) or of the lows and highs of your business cycle.

**How much will I spend?** The answer to this question relates directly to how much advertising you plan. In turn, how much advertising you plan will be conditioned by how much money you can spend.

Some retailers allocate a percentage of their gross sales as the amount of money to be spent on advertising. The difficulty in using such a method is the establishment of a criterion on which to base the percentage. Percentages of advertising costs by types of retail shops do exist and can be obtained for use as a guide from various

retail trade associations. The norms for most small retailers range from 2% to 5% of gross sales with the rule of thumb being 3%.

As well, the type of retail business that you have will determine what you spend on advertising. For example, a grocery store with weekly or daily specials will spend more on advertising than a hardware store. If you are a new retailer, your advertising budget will be higher than a well-established shop. This is because you must build up customer traffic for your shop. Competition is also a factor that determines how much you spend. If you face strong competition and must fight for your share of the market, your advertising budget will of necessity be higher than if your competition was weak.

Experience is usually what teaches you which advertising is effective and how much you should spend. It is important to stress that you keep accurate sales records so that you can make comparisons of periods in which you advertise and in which you did not. Nevertheless, an amount of money should definitely be set aside for advertising. It is a necessary expense in operating your retail business.

## **II. Selecting the advertising media**

**When selecting advertising media, you should first determine that:**

- the medium is compatible with your image and product;
- the medium is suitable for your market and geographical area;
- the medium serves effectively your geographical area;
- and, the medium is within your budget.

Before examining the basic types of advertising media available to the retailer, we should briefly comment on the above points. The medium should be compatible with your image and product. This means that our top quality furrier will not likely use transit advertising. The medium must be suitable for your market and geographical area. Our kite shop, therefore, will not advertise in a business publication. The medium must effectively serve your geographical area. Accordingly, if you have a choice of your local town newspaper or a major newspaper delivered to your town from a city fifty miles away, you will advertise in the local paper. The medium must be

within your budget. Television advertising may be effective in your city but the price may be prohibitive for you.

It is important, at this point, to remind you of the earlier section of this chapter entitled "Knowing your customers". Because you know your market and location of your existing and potential customers, you are able to choose the most appropriate advertising medium. Without this knowledge, there is always the risk that you could use a medium that either spreads your message over too wide an audience or, partially or completely, misses your market target.

The order in which we list the advertising media does not reflect on their relative importance. Each medium serves a particular purpose and it is up to you to choose the one or ones suited to your business.

**Newspapers (daily & weekly).** Newspapers constitute the favourite medium for retail advertising. This is especially true for the retailer whose type of customer is the general public as newspapers are read by all people. Newspaper advertising is flexible. This means your advertisement can be any size, contain whatever words and illustrations you wish, and can be inserted wherever there is space available.

Many newspapers regularly have advertising supplements or special advertising pages that are features expected by the reader. With daily newspapers, many shoppers specifically buy papers on certain days such as Thursday, Friday and Saturday which are days of heavy advertising. Remember that advertisements can be placed both as display ads and as classified ads.

The disadvantage of a daily newspaper, if it is from a major urban centre, is that the readership territory may far exceed that of your geographical market area. The result is that you are paying for an advertisement that will be read by people whose location realistically prohibits them from being your customers. If your shop is selling to a special type of consumer, such a general public medium as a daily newspaper may not be ideal.

Local newspapers should not be overlooked. Most of them will be weekly and will serve a specific geographical area. Some local newspapers are distributed free to households within the area. Often

a local weekly newspaper, because of its very parochial nature, will receive more attention than a big city daily. A number of local newspapers exist that consist almost entirely of advertisements. Papers such as these are almost always free and are delivered to the households in the community.

Other types of newspapers include the ethnic press, or newspapers put out by special interest groups. If your products can appeal to these readers, this type of paper can be another place for your advertisements.

When selecting a newspaper for your advertising, be it a daily or a weekly, ask what the circulation is and where the readership is located. You will want to relate this to your geographical market area.

**Flyers (handbills).** These are usually unaddressed sheets that constitute either one advertisement from a single retailer or contain a number of advertisements from a number of retailers. Their distribution time is decided by the advertising retailer. The distribution itself can be controlled by the retailer to any geographical area or type and size of household. The advertisements generally feature certain products or special discount sales. The relatively moderate cost (compared to other media) and the aspect of controlling the distribution make them an effective medium for the retailer with a local market.

**Direct mail flyers.** Unlike handbills, these flyers are addressed and sent through the mail to a selected group of people. Because the flyer (often more than one page) is addressed, the recipient is less inclined to immediately discard the flyer as "junk mail".

Direct mail houses exist that not only prepare the flyers but which also supply names and addresses of appropriate consumers. Often, though, names and addresses are supplied by the retailer through the use of customer files. This can avoid the risk that the list, prepared by the direct mail house, contains poorly selected or out-of-date names.

Direct mail advertising can be not only in the form of flyers, but can be cards, letters or booklets. The purposes of direct mail advertising can range from announcing a special sale or new products

to informing the consumer of your business if you are using names not supplied from your customer files.

**Magazines.** Consumer magazines are either national or local. Some national magazines have regional editions that will take advertising from retailers in those particular regions. Magazines can be either of general interest or of special interest.

The major advantages of a magazine are that its reading time is longer than that of a newspaper and that the magazine is retained for a longer period of time. The disadvantages are usually the time lag between presenting your copy for an ad and the publication date of the magazine. Also, the ads may have limitations of style and size so as to conform to the magazine's image. Often, a magazine may cover too large a geographical area for the small retailer or the expense for advertising in a magazine may be too high.

A special interest magazine, if it relates directly to your special product (a cycle magazine and you sell motorcycles) may be a good place for your ad if you know for sure that people in your geographical market area read this particular magazine. Local consumer magazines (weekend newspaper magazines, visitor magazines, or similar) take advertisements from retailers. Generally, these magazines are only to be found in large urban centres.

**Transit advertising.** This medium of advertising is available usually in large urban areas. It consists of standard size cards displayed inside buses or subway cars, of large posters attached to the outside of buses, and of framed posters in bus and subway terminals. Some taxis are also now starting to carry card ads. Often, the retailer is able to choose the bus and subway routes on which his or her ads are to appear. While your advertisement will be seen by a great number of people, it is difficult to assess the effectiveness of this medium. Generally, retailers use this medium to put, or keep, their name and location in the public eye.

**Billboards.** Sometimes referred to as outdoor advertising, billboards usually are the advertising domain of the large or national retailer. Because of the vast amount of repetitive travelling done by a large part of the population, a strategically placed billboard is seen by many people. Though this is true, it is difficult to assess the

effectiveness of using this medium for the small business. Costs for renting space on a billboard can be high. There may also be difficulty in getting a chance to rent space. This is often due to the fact that existing advertisers will use a billboard for long periods of time. If a large number of billboards are close together in one advantageous location, there is always the risk that no individual sign will be prominent.

In considering billboards, you must recognize the growing number of restrictions against this medium under the argument of visual pollution. Billboards, when used by retailers, usually just inform the public of the retailer's existence.

**Radio.** Advertising on the radio can be effective for the majority of retailers. Radios are listened to at breakfast, on the way to and from work, during housework, in the evenings and at night.

To effectively use the medium of radio, retailers must ensure the compatibility of their existing and potential customers to the radio station. Radio stations develop their broadcasting formats to fit specific audiences. Some radio stations have a constant format (country and western music, hard rock music, talk shows, sports) while others vary the format during the day for different audiences. Therefore, when advertising on the radio, you must choose carefully not only the station but the times at which each type of audience will be tuned in. You should also have an idea of when your customers will be listening so as to place your ad at the most effective time.

When choosing a station, ask for their listener profiles and transmission patterns for the different times of the day. Knowing your geographical area, you will want to be sure that the radio station is serving it.

Broadcasting your advertisement at prime time, such as during the morning drive and before newscasts, carries a higher cost than does broadcasting at other times. This is because these times are recognized as having the most advantageous number of listeners. Often, it can be difficult for a new retailer to get these time slots.

Most radio ads are 30 seconds or 60 seconds long. Because you cannot be sure that a customer will be listening at the moment

of your ad or will remember it, repetition becomes a necessity. Repetition also costs money. The definite advantage of a radio ad is that, while it is being broadcast, no other ads are competing (at least on that specific station). Radio ads can also be prepared and, with little delay, can be broadcast.

**Television.** While the production cost of television is expensive when compared to other media, the cost per thousand reach is usually less expensive. Generally, television does not appear in the advertising program of most small retailers. The primary advantage of television ads over radio ads is their visual aspect.

**Other media.** Media, other than what we have so far described, include directories, other printed materials, and the telephone.

Directories, especially the yellow pages of the telephone book, are a good and inexpensive means of informing the public about your shop. Often these directories accept not only just a listing of name, location and telephone number, but also display advertising. Shoppers who use directories are those who have decided to buy a certain product and are looking for a shop from which to buy it.

Other printed materials destined for the public include programs (theatre, sport, entertainment) and year books or similar from clubs and associations. These publications often take advertisements from retailers. Their effectiveness as a generator of sales can be doubtful. Retailers who place ads in such publications, especially those of clubs and associations, do this more for good public relations than for obtaining sales.

Some retailers use the telephone as an advertising medium. Using names and telephone numbers in their geographical market area, they make contact and impart their message. Telephone soliciting is a risky proposition as it can be resented by the householder as an unwanted intrusion.

### III. Putting the advertisement together

In having an effective advertisement, the important words today are "short" and "simple". People do not have time to read and listen to complex, long messages. As well as any message, your

ad must also state your shop's name and location and, it should be repeated. The tone of your ad should consider whom you want as an audience. A folksy approach may not go down well if you are trying to get affluent customers for your top quality fur salon. Also, a positive quality must exist in your ad; showing the customer the benefit in buying from you.

When putting an ad together, first decide what you really want to say. Do not try and say too much because a lot of words can mean your important point is lost. Second, write your ad in rough and see how it reads. Then see what you can eliminate without cutting the important point you want to make.

Remember that each medium has its own individual presentation and that the audience today expects professionalism. If you are unsure about putting your advertisement together or are concerned with graphics, get help. Most of the media people, with whom you will deal concerning your advertisements, are in a position to help or make suggestions. They want you as a repeat advertiser and you will only repeat your ad if you are satisfied with it. Advertising agencies, on a fee basis, can also provide you with assistance. Some agencies, of course, prepare and handle the complete advertising program for a retailer.

**Note:** Be careful in the claims that you make about either your shop, your products or your prices. Exaggeration, misleading, and untrue statements can put you in trouble not only with the consumer, but also with regulatory agencies. Information is available from the Department of Consumer and Corporate Affairs as to what constitutes false or misleading advertising.

Before your advertisement is either printed or broadcast, see a copy of it first. Read and check the ad or "proof" for any errors, misprints, etc. before you authorize it. Mistakes are distracting, can be costly, and cut the efficiency of your ad. Be especially careful with advertisements prepared for you by others.

## DISCOUNT SALES

While the usual reason for a discount sale is to clear slow moving or dead merchandise, many retailers use special sales as part of attracting and keeping their customers. A special sale creates extra business by drawing more shoppers into the store than usual and, through advertising, creates the image of a place where good deals are possible.

Depending on your shop's image and products, you may plan to have special sales regularly throughout the year. These special sales then become established with your customers. Fall or Winter clearance sales, year-end inventory sales, white sales, Summer clearance, Mother's Day, after Christmas sales are some of the types of discount sales offered by retailers. Be careful in having too many discount sales. Your marked down merchandise must keep a proper relationship with your regular merchandise. Do not sacrifice your overall margins for high volume sales based mainly on markdowns.

The success of a special sale depends largely on adequate thought and preparation. Decide what merchandise you are to feature for a special sale. Also make sure that you have enough merchandise to warrant an advertised special sale. Check your costs and selling prices and determine how much discount will be required to definitely move the products and how much of markdown you can afford. When applying markdowns, you have a choice. Either you can group similar products and give an overall markdown for the group (e.g. 33  $\frac{1}{3}$ % off) or you can markdown individual items. In the latter case, many shoppers will be inclined to only buy the better bargains leaving the items with smaller markdowns.

When selecting and evaluating merchandise for a discount sale, make notes. This will help you in writing your advertisement. The ad must be attention-getting and emphasize the good deal aspect. Your advertisements for a discount sale should appear a full week earlier. At this stage, you may wish to contact existing customers by telephone or by a direct mail advertisement to give them, as good customers, notice of the sale in advance of the general public. An offer to them to shop for bargains before the sale officially begins can build good customer relations.

Your sale preparation includes getting the shop ready. For the day of the sale, your shop windows should have stickers or signs to inform passersby of the sale inside. Inside the shop, the sale items should be identified and be in a strategic location; one that brings the shoppers past your regular merchandise. Interior signs should reinforce the aspect of the discount. When price tagging the merchandise, show the regular price so it can be compared to the marked down price.

Your staff plays an important role in a special sale. Discuss the sale with them, get them mentally and physically prepared for a sale and, maybe, offer incentives. During the sale, instead of using pressure selling tactics, the staff should sell by helping the customers. They should point out the bargains and make suggestions.

While the sale is underway, monitor the merchandise. Check what products are not moving and maybe rearrange or increase the markdown on individual items. You may want to repeat your advertisements with the incentive that only so many days are left. If the sale is going well, you could have the option of marking down more merchandise. Of course, you must keep in mind the requirement of overall profit and be sure that you will have enough unit sales to compensate for the markdowns.

## CONCLUSION

Regularly switch your role from that of a retailer to that of a shopper and have a close look at your shop. How does the shop rate? Is the exterior attractive? How inviting is the interior? Is the staff friendly? What are the shop's advertisements like? Are they appealing, yet truthful? After these and similar questions, you finally ask: Why should I buy from this particular shop and not from another?

The answer to the last question is what you tell the consumer through your advertisements. You support your answer by your promotion.



The Federal Business Development Bank also publishes a free quarterly news bulletin called "Small Business News" to help smaller Canadian firms keep in touch with business developments. This can be obtained by contacting any office of the FBDB or by using the following order form:

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(please write in)

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(Please print or type)

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Business (if any): .....

Address: .....

City: ..... Prov. ....

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# FINDING YOUR OWN BUSINESS

VOLUME 3

Government  
Publications

CAI  
FBI  
SAM39

Buying a franchise .....	7
Buying or starting a restaurant .....	23
Controls for your restaurant .....	53
Restaurant advertising and promotion .....	81
Buying or starting a motel/inn .....	103
Buying or starting a service business ...	133





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# CONTENTS

FOREWORD .....	5
CHAPTER 1 Buying a franchise .....	7
CHAPTER 2 Buying or starting a restaurant .....	23
CHAPTER 3 Controls for your restaurant .....	53
CHAPTER 4 Restaurant advertising and promotion .....	81
CHAPTER 5 Buying or starting a motel/inn .....	103
CHAPTER 6 Buying or starting a service business .....	133



# FOREWORD

The service industry provides services wanted by both business and the public. The types of service businesses to be found in Canada are numerous; they range from consulting firms, hairdressing salons, and plumbing services, to sellers of computer software, and telephone answering services. Restaurants also comprise a large section of the service industry.

The chief inventory of these businesses is the capacity of the people working in the business to render or sell the service. You, as the owner of a service business, are the business's most important asset. Not only must you be proficient in the service you are selling but you must be able to manage the business at the same time.

The first chapter in this volume introduces the reader to franchising: the viable alternative to buying an existing business or starting one from scratch. Many service businesses are available to entrepreneurs as franchises. The following three chapters on restaurants outline how to get started as well as introducing and explaining good management in the various aspects of owning a restaurant. A chapter on buying or starting a motel/inn follows.

The last chapter looks at those types of businesses that sell only a service; the business where no physical product is exchanged.

The material for this volume was compiled from many interviews with people who have owned and managed their own service business. These experts are directly involved with helping service businesses through the Federal Business Development Bank's CASE program. CASE (Counselling Assistance to Small Enterprises) is a counselling service available to both new and established small businesses.



# 1. BUYING A FRANCHISE

*"A franchise must do something for you, that you, on your own, could not do so readily for yourself." — CASE Counsellor*

INTRODUCTION — WHY BUY A FRANCHISE? .....	8
DEFINING A FRANCHISE	
i WHAT IS A FRANCHISE? .....	8
ii BUYING A FRANCHISE OR STARTING YOUR OWN BUSINESS ..	10
BEFORE BUYING A FRANCHISE: INVESTIGATE .....	11
WHAT TO EXAMINE WHEN BUYING A FRANCHISE .....	14
CHECKLIST .....	18
CONCLUSION .....	21

## **INTRODUCTION —**

### **WHY BUY A FRANCHISE?**

Buying a franchise could be a viable option for getting into business for yourself. No longer is your choice limited to buying an existing business or starting a new one. Basically, there are three reasons why you may wish to become a franchisee.

The first reason is that you have the desire to be in business but lack the required expertise. Buying a franchise usually means that you will not only receive the necessary training from the franchisor, but will also work within proven operating guidelines.

The second reason is that you may be reluctant to invest your money in a high risk venture. This can be the case when starting a new business of your own. Buying a franchise usually means your investment risk is lower since you will operate under an established name or trademark where the product or service offered is familiar to the public. Also, a franchise is usually only established as a result of extensive planning and marketing on the part of the franchisor.

The third reason is often one of expecting a quick return on your investment. There are cases where people have bought a well-known franchise and have been successful right from the start.

The most important element of a successful franchise is good management. Good management does not come with the franchise package that you buy. It comes from you, the purchaser. This chapter advocates that your good management begins with (1) a basic understanding of what a franchise is, and (2) knowledge of what must be investigated before you buy a franchise.

### **DEFINING A FRANCHISE**

#### **i. What is a franchise?**

A franchise is a contractual privilege granted by one person or company (the franchisor) to another person or company (the franchisee). The privilege granted by the franchisor to the franchisee is the right to sell, in a specified manner, a particular product or service within

a specified territory. The product or service is usually identified by a trade name, trademark, logo, or other commercial symbol over which the franchisor has exclusive control.

**A franchise can be further defined by being divided into two general categories:**

- “product distribution” in which a retailer enters into an agreement with a franchisor to sell, within a specified territory, particular products identified by the franchisor’s name and/or trademark. The retailer, while identified to a certain degree with the franchisor, nevertheless retains his or her own identification. (Example: an independent car dealer carrying a certain line of automobiles.);
- and, “entire business franchising” in which a franchisee agrees to sell, within a specified territory, goods or services under a system and in a format prescribed by a franchisor. The operation, or system and format, of the franchisee’s business is almost completely identified by the name, trademark, etc. of the franchisor. (Example: a fast food restaurant.)

The first category “product distribution” is considered more akin to starting your own business but with the advantage of selling a known product. “Entire business franchising”, which we deal with in this booklet, is where you purchase a “package” to put yourself into business. How does it work?

A franchisor has developed a product and/or service along with a certain format of operating a business. The product, service, and method of operating the business are identified by the franchisor’s name, trademark, or other owned commercial symbol. To become a franchisee, you enter into an agreement with the franchisor whereby, for a certain amount of money, you will have the “right” to sell the franchisor’s products and/or services. You will also agree to operate your business in conformity with the franchisor’s established methods. Your “right” is usually specified for a period of time and to a territory.

The franchisor provides you with a proven product or service along with marketing know-how and standardized operating methods. You have the benefits of the franchisor’s name and goodwill, product and service research, management training, and group purchasing ability.

Of course, you benefit from the profits on your sales. In turn, the franchisor benefits from your purchase fee and, possibly, royalties or service charges. The most important benefits to the franchisor are having you as a captive outlet for buying the franchisor's products and as a method of promoting the franchisor's name.

## **ii. Buying a franchise or starting your own business**

To understand fully what is meant by a franchise, it can be helpful to know the major differences between buying a franchise and starting your own business.

### **Buying a franchise**

- Operational training usually provided by franchisor.
- Right to use a known trade name or trademark. Franchise operation completely identified with franchisor.
- Able to sell a proven product or service with established public acceptance.
- Buying a package, so ready to start full operations sooner.
- Less working capital may be required because of tighter controls and franchisor's terms of merchandise supply.
- Profit and loss forecasts may be more accurate as based on proven similar operations.
- Greater chance of initial success.

### **Starting your own business**

- Management ability based on your own expertise.
- Time required to establish name. But more identification of owner to business.
- Time required to establish name, products, and/or service.
- May have to start slowly. Longer time to realize full potential.
- Risk of mistakes and longer time to start can mean greater financing needs. Terms may be difficult to get with suppliers.
- Risk of errors in estimating expenses, sales, and profits especially for an unproven venture.
- Greater chance of failure due to time required for establishment and possibility of mistakes especially re marketing and planning.

### **Buying a franchise (cont'd)**

- Sales territory defined by franchisor.
- Benefit from standard national and local advertising of prices, products and service.
- Franchisor is often sole source for merchandise.
- Fixtures, equipment, and premises often specified by franchisor.
- Contractual arrangement in force covering all aspects of operation and duration of franchisee's right to operate the franchise.

### **Starting your own business**

- No restrictions on expanding territory if successful. No risk that expanded territory already has identical operation to yours.
- Freedom to advertise when you want to and can afford to, and to set your own specials or discounts to meet competition.
- Can buy from any supplier so as to get best prices and terms.
- You decide on premises, equipment, and fixtures based on the image you want and your available capital.
- Total freedom to operate as you see fit and to sell or close the business when you want.

## **BEFORE BUYING A FRANCHISE: INVESTIGATE**

If you were to buy an existing business, you would of course check into all aspects of the operation before you handed over your money. Why? Because you are investing money to make money and are looking for a better than average return. Therefore, you want to find out if anything is wrong before you buy, not when you become the owner.

Buying a franchise should be looked upon as buying an existing business. The same investigation is required. You want to be sure that you know and understand all aspects of the franchise package that you are purchasing. Let us examine the following situation which clearly illustrates the need to investigate when buying a franchise.

Peter and Tony Brown, two brothers, bought a Danny Donut Shop franchise early in the year. They paid the franchisor \$12,000. But now, to their dismay, their total commitment is almost \$100,000 which they have had to cover with loans, guarantees, and a personal mortgage. Peter and Tony are not happy with their situation.

"We're making money, but..." said Tony, one evening after they had closed.

"I know," replied Peter. "But not as much as we expected. We should have checked those market estimates that the franchisor gave us."

"We could have spoken to that other Danny Donut Shop franchisee out in the suburbs. He'd have given us a good idea of what to expect."

"Well, there's a new Danny Donut Shop coming into town. Do you want to do him a good deed and talk to him?" suggested Peter.

"What do you mean, another franchisee?" asked Tony indignantly. "The city is our territory!"

"The contract we signed says the city is our territory in the sense that we have the right of first refusal on any new franchises. Do you think we can afford to buy another Danny Donut Shop franchise?" asked Peter.

"No way," said Tony shaking his head. "Not after all the money we had to lay out for equipment and fixtures. Sure the franchise purchase price was a good deal, but I thought we could have bought just any equipment and preferably secondhand."

"Our contract specified new equipment. And, as you know, it specified the type of cookers, counters, everything in fact that we needed, along with the supply source."

"OK," interrupted Tony, "the shop looks nice but they wouldn't let us even modify the layout. If we had smaller tables, we could get more people in. But our franchisor said no."

"It's all in the contract," answered Peter flatly. "Just like I had to say no to that fellow who said he could sell us donut batter cheaper than what we buy from the franchisor."

"Why say no?" asked Tony. "That's the only way we can increase our margin, seeing that the franchisor won't let us adjust our retail prices."

"Sorry, Tony. The contract says we buy our batter and all other supplies from the franchisor."

Driving home with Tony, Peter remembered something else concerning their Danny Donut Shop franchise.

"I got a call from the franchisor's agent, today. We're late on our six-month royalty payment."

"What do you mean by a 'royalty payment'? We paid the purchase price and we pay a service fee. What is this royalty business?" queried Tony.

"That is in the contract also," explained Peter patiently. "Over a certain volume of sales, we must pay the franchisor a royalty."

"And of course," added Tony, "the franchisor is always sending his agent down to check our operations and to see our books. So he'll always know what our sales are."

"They have to send someone down to make sure that Danny Donut Shop standards are the same everywhere. We've agreed to operate by their rules. It's in the contract," said Peter.

"It's a pity that you know the contract only now," commented Tony bitterly.

"It's both our faults," retorted Peter. "We should have examined the contract more carefully and should have checked out everything about the franchise first."

A bona fide franchise is not something that involves trickery. It is a business agreement entered into freely by two parties whose obligations and actions in their respective roles of franchisor and franchisee are spelled out in a binding, written contract. The problem, as in the case of the two Brown brothers and their franchise, usually is one of a lack of understanding.

This lack of understanding can only be solved by a proper investigation on the part of the prospective franchisee. The investigation must not only protect the franchisee from possible fraudulence but also from misconceptions and unrealistic expectations. The next section of the chapter looks at what to examine when buying a franchise.

## WHAT TO EXAMINE WHEN BUYING A FRANCHISE

What do you check into when buying a franchise? An easy answer to that question is: everything. While it is impossible to list everything that you must investigate when contemplating the purchase of a franchise, we do list some main points. From these points, you should be able to develop other questions to ask.

**The franchisor** Find out who the principals are and what their business background is. Is their business history connected with the product or service they are franchising? The answer should be yes if you are depending on them for expertise in running your franchise. Have there been, or are there any, civil or criminal actions against them? Are the franchisors successful business people in their own rights? Is the franchisor a multinational company, a national company, or a comparatively small enterprise?

**The franchise** Exactly what does the franchisor own or control (trade name, trademark, product, process) and when will this ownership or control expire? How well-known is the franchise operation? How long has the franchise operation been in existence? Is it a growing franchise, yet well established? Find out the number of franchises already established and obtain the names and addresses of the franchisees. This is invaluable in checking for candid facts. You should definitely evaluate at least one of the established franchises to determine for yourself how successful the venture is. Have any franchisees failed and, if so, why?

**Sales and profit** Obtain an estimate of the amount of sales that the franchise will generate. These estimated figures should be not only for your proposed first year of operation but for as many years ahead as is realistically possible. The estimates that you obtain should be checked with the actuals from existing franchises. It is important that you undertake a market study of your own so as to assess your share of the market. It may well be that the franchisor's estimate is overgenerous or does not consider the time factor necessary for you to reach the potential of full earnings.

**Location and premises** Who decides the location of the franchise — you or the franchisor? Will the franchisor help you find a location in your territory? Make sure you are satisfied with the location for it must be the most suitable one, from a market point of view, for you. Do your premises have to meet certain standards such as square footage or street frontage? Can you adapt existing premises to house your franchise operation or must you operate in new premises? If premises must have a standard appearance to conform to the franchise image, do you know who pays for this? Must you construct your own building (if new premises required) or does the franchisor do this and you only lease? If you lease, is it specified for how long and can you sublease or move your franchise operations to another location within your territory? Find out if it is advantageous to set the term of your lease to the term of your franchise agreement.

**Equipment, fixtures, layout** Check if the franchise agreement calls for specific equipment and fixtures. In many cases, this is required so that each individual franchise operation presents a uniform appearance. If this is true for your operation, find out if you must buy the items from a specified source (such as the franchisor) or can shop around for the best deal. If you must buy from a named source, find out if you can arrange terms. If leasing the equipment and fixtures from the franchisor, make sure you understand the terms. What about warranties and repairs to equipment and fixtures? The layout of your operations may also be specified. Verify what input you can have or what adaptations, if any, you can make.

**Protection of territory** Has your territory been defined? And is it clearly defined even to the point of being marked on a map? For how long a period of time is this territory exclusively yours? What is the protection — that no other franchise will be sold in your territory for so

many years or, that you have first refusal on any new franchise in your territory? Make sure that any offers for first refusal will not come too soon before you have benefited fully from your first franchise operation. Also, check that the contract does not specify that, in order to retain exclusive territory, you must buy more franchise operations. Can your territory be reduced at any time by the franchisor? Can you expand your territory?

**Purchase costs** You must know what all the purchase costs are. What is the total franchise fee and what are you really buying? Does the "package" cover just the right to use a name or trademark, or are you also buying initial inventory, equipment, and fixtures? Is the franchise fee a one-time payment or must you pay again when renewing your contract? Are there service charges or royalties specified such as a percentage of gross sales? Are terms available with the franchisor? Can the franchisor help you arrange financing? Who pays the legal fees? Who pays for permits, licences, and insurance? Are there penalty clauses? If you are leasing the premises or equipment from the franchisor, do you have to make advance payments or leave a damage deposit? If buying equipment and fixtures, when and how do you pay for them?

**Training** Find out if the franchisor will give you training. If the answer is yes, find out who pays for it. The training may be a "once only" affair or it may consist of an initial indoctrination followed by refresher sessions. What does the training consist of — management skills, product or service skills, operational skills, or a combination of all aspects? Are there training courses available for your employees and, if so, who pays for them? Can you telephone the franchisor for quick advice?

**Prices and sales** Do you have the right to adjust the prices or are they set by the franchisor? Can you offer specials on your own? Are there sales quotas and are they realistic? What happens if you do not meet minimum quotas?

**Products and supplies** Is it specified in the contract what products you must carry? Can you stock product lines other than the franchisor's? Are the sources specified for your purchases of products and supplies or can you shop around for a better price? What are the payment terms? Is there a chance that your supplier could run short? Are there minimums specified for order size?

**Business controls** Usually, franchisors will spell out how a franchisee will operate his or her franchise. This may be looked upon as a curtailment of freedom. Nevertheless, it must be recognized that this is the way the franchisor obtains uniform standards of image from all his or her franchises. These controls usually include advertising policies, insurance policies with the franchisor as beneficiary, hours and conduct of business, accounting procedures, reports from the franchisee to the franchisor, and even access to the franchisee's records and bank. Often, business controls can mean that the franchisee must run the business in person and cannot designate a manager. The contract may also state that the franchisor has the final word in any disagreement between the franchisee and the franchisor.

**The franchise contract** You must understand every clause of the contract. You must make sure that all obligations and freedoms are specified in the agreement. Check, especially, clauses pertaining to termination, bankruptcy, transfer, renewal, and sale of the franchise. What are the conditions under which the franchisor has the right to revoke the franchise agreement?

**Note:** Two important people who must help you when examining the purchase of a franchise are your accountant and your lawyer. Have your accountant prepare a forecast of your franchise operation and assess your return on investment. Remember, you are not just purchasing a franchise, you are also going to operate one. Working capital is a definite requirement. What will your lawyer do? He or she will explain every clause of the contract to you and, if necessary, will write in additional clauses to be negotiated with the franchisor, and will be there to protect your rights.

To conclude this section of the chapter, it is important to stress that you must not be afraid to ask questions. Visit other franchisees and ask about the franchisor. Check with the Better Business Bureau, credit reporting agencies, banks, Chambers of Commerce, the public record, newspaper files, and anybody or anything that will help you get the information you need. Remember, it is your money that you are investing. Be sure that you know and understand fully the agreement and your involvement in the franchise.

## CHECKLIST

This section consists of a checklist for you to complete. Some of the questions have been examined in the chapter, while other questions are there as an inducement to enquire further into the aspects of buying a franchise. You may also wish to use this checklist as a guide when initially contemplating the purchase of a franchise.

## QUESTIONS

### EVALUATION TO BE A FRANCHISEE:

	YES	NO
Do you know why you want to buy a franchise?	<input type="checkbox"/>	<input type="checkbox"/>
Are you relating your interests to the right type of franchise?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have the physical and educational requirements to be a franchisee?	<input type="checkbox"/>	<input type="checkbox"/>
Is your work experience related in any way to the type of franchise you want to buy?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have good learning abilities?	<input type="checkbox"/>	<input type="checkbox"/>
Are you prepared for hard work and financial risks?	<input type="checkbox"/>	<input type="checkbox"/>
Can you manage staff?	<input type="checkbox"/>	<input type="checkbox"/>
Can you work under rules and controls to be specified by the franchisor?	<input type="checkbox"/>	<input type="checkbox"/>

### THE FRANCHISOR:

Do you know who the principals are?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know their personal and business history and is it related to the franchise?	<input type="checkbox"/>	<input type="checkbox"/>

### THE FRANCHISE OPERATIONS:

Are the franchise operations well established?	<input type="checkbox"/>	<input type="checkbox"/>
Is it a growing business with an indicated good future?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what the franchisor owns or controls (trade name, trademark, product, process)?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Have you found out the names and addresses of other established franchisees?	<input type="checkbox"/>	<input type="checkbox"/>
Have you visited and talked with these other franchisees?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Sales and profit:</b>		
Have you estimated sales, expenses, and profit and, if possible, compared them to an existing franchise?	<input type="checkbox"/>	<input type="checkbox"/>
Has a professional accountant helped you?	<input type="checkbox"/>	<input type="checkbox"/>
Have you studied the market?	<input type="checkbox"/>	<input type="checkbox"/>
Have you assessed your share of the market?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Location and premises:</b>		
Can you choose your location?	<input type="checkbox"/>	<input type="checkbox"/>
Is your location the best one for you?	<input type="checkbox"/>	<input type="checkbox"/>
Are there standards for location and premises specified by the franchisor?	<input type="checkbox"/>	<input type="checkbox"/>
Can you make any adaptations to the location and premises?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if you must lease or buy your premises?	<input type="checkbox"/>	<input type="checkbox"/>
If so, have you checked the terms?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Equipment, fixtures, layout:</b>		
Are the equipment and fixtures specified?	<input type="checkbox"/>	<input type="checkbox"/>
Must you buy or lease the specific equipment and fixtures only from the franchisor?	<input type="checkbox"/>	<input type="checkbox"/>
If so, are the terms and prices reasonable compared to other sources?	<input type="checkbox"/>	<input type="checkbox"/>
Is the layout specified by the franchisor?	<input type="checkbox"/>	<input type="checkbox"/>
Can you make adaptations to the layout?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Protection of territory:</b>		
Is your territory well defined?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you know how your territory is protected?	<input type="checkbox"/>	<input type="checkbox"/>
Can your territory be reduced or expanded?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Purchase costs:</b>		
Do you know what the franchise fee entitles you to?	<input type="checkbox"/>	<input type="checkbox"/>
Is the franchise fee a one-time payment?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked for royalties and service charges?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know who pays for the legal fees, permits, licences and insurance?	<input type="checkbox"/>	<input type="checkbox"/>
Have you made financial arrangements for equipment and premises?	<input type="checkbox"/>	<input type="checkbox"/>
Can you arrange financing with the franchisor?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Training:</b>		
Will the franchisor train you and your staff?	<input type="checkbox"/>	<input type="checkbox"/>
If so, do you know who pays for this?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Prices and sales:</b>		
Are prices set by the franchisor?	<input type="checkbox"/>	<input type="checkbox"/>
Can you adjust the prices or offer special discounts?	<input type="checkbox"/>	<input type="checkbox"/>
Are there sales quotas and are they realistic?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what happens if you don't reach the quotas?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Product and supplies:</b>		
Must you carry all the franchisor's product lines?	<input type="checkbox"/>	<input type="checkbox"/>
Can you stock product lines other than the franchisor's?	<input type="checkbox"/>	<input type="checkbox"/>
Is the source for products and supplies specified?	<input type="checkbox"/>	<input type="checkbox"/>
Can you arrange terms for the products and supplies?	<input type="checkbox"/>	<input type="checkbox"/>

**Business controls:**

Has the franchisor specified rules and regulations in running your franchise?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what all the rules and regulations are?	<input type="checkbox"/>	<input type="checkbox"/>
Are you in agreement with them?	<input type="checkbox"/>	<input type="checkbox"/>
Can these rules and regulations be adjusted?	<input type="checkbox"/>	<input type="checkbox"/>

**THE FRANCHISE CONTRACT:**

Do you understand all clauses of the contract?	<input type="checkbox"/>	<input type="checkbox"/>
Is everything that you want written in the contract?	<input type="checkbox"/>	<input type="checkbox"/>
Have you especially checked the conditions of termination, bankruptcy, transfer, renewal, and sale?	<input type="checkbox"/>	<input type="checkbox"/>
Has your lawyer carefully read each clause and explained it to you?	<input type="checkbox"/>	<input type="checkbox"/>

## CONCLUSION

Buying a franchise is a definite option available to you for getting into business for yourself. Buying a franchise package may mean buying training and the franchisor's expertise. But to have a successful franchise operation, you, yourself, must provide good management.

Your good management comes into play before you buy the franchise. How? The answer is:

- (1) by making sure you understand fully what constitutes a franchise so that you are certain that buying a franchise fits your lifestyle;
- (2) and, by investigating completely the franchise offer to be sure that your investment is safe and that you know the business will generate enough income to meet your current and future financial needs.



## 2. BUYING OR STARTING A RESTAURANT

*"Before you buy or start a restaurant, be sure you know what you are getting into." — CASE Counsellor*

INTRODUCTION .....	24
YOU AS A RESTAURATEUR .....	24
CHOOSING YOUR TYPE OF RESTAURANT .....	28
WHAT TO LOOK FOR	
WHEN BUYING OR STARTING A RESTAURANT .....	31
ASSESSING THE PROFITABILITY .....	39
i ASSESSING THE ESTABLISHED RESTAURANT .....	40
ii ASSESSING THE START-UP OF A RESTAURANT .....	42
FORECASTING THE PROFITABILITY .....	43
CHECKLIST .....	47
CONCLUSION .....	52

# INTRODUCTION

You might think that managing a restaurant is an easy task. That may be the reason why so many people every year either buy or start their own restaurant.

Making money, being your own boss, fulfilling a personal dream, and an interest in food are all good reasons for going into the restaurant business. Besides, it can be fun and rewarding. A feeling of accomplishment is well-deserved if your restaurant adds something to the prestige of your community.

Yet, a successful operation does not just happen. It takes careful planning before you start. Careful planning requires a good understanding of what is involved in the restaurant business. The hours are indisputably long; the job is tough and demanding, and going into this type of business can be a gamble. Fortunes are lost and dreams are shattered when poorly managed eating establishments go under after only a few months or years. The Canadian Restaurant and Foodservices Association reports that eight out of ten restaurants started in Canada fail within three years of opening. That should be enough reason for a prospective restaurateur to ensure that he or she is well-prepared.

Going into the restaurant business is not something you should decide to do on the spur of the moment. There are many points to consider. To help you, this chapter examines some of the major aspects you should consider before purchasing or starting a restaurant.

## YOU AS A RESTAURATEUR

Whether or not you are suited to the restaurant business can also make a difference as to how successful you are. It is good management, and not good intentions, that will give you that head start in your restaurant.

Let us examine the situation of Ed and Nancy. Their experience will clearly illustrate that good management means first knowing what the restaurant business is all about before buying or starting one.

After several attempts at various careers, Ed wanted a change. He and his wife Nancy decided that they would try the restaurant business. With Nancy doing the cooking and with Ed's management ideas, they were sure they would be successful.

Ed based his decision to go into the restaurant business on the year he spent working as a waiter. He really liked that job. He got along well with customers and he got good tips. He was tired of working for someone else however, and he thought he would be more successful as his own boss. Now was the time to go on his own, he thought. He was only 36 years old and still young enough to take a chance.

Nancy was keen on the idea of going into the restaurant business because she loved to cook for family and friends. She was often asked to cater for her friends and for the service organization to which her husband belonged.

The restaurant that Ed and Nancy chose to buy was located on Main Street and was a family restaurant with counters and booths. The owner had been ill for a long time and after his death the restaurant was put up for sale. The price was higher than they had anticipated, but with a second mortgage on their house and with a loan from Ed's parents, they bought the restaurant.

Ed realized that the restaurant had not been doing too well over the last year but he felt that this was due to the owner's illness and subsequent death. If he and Nancy worked hard, thought Ed, they would make money.

While Nancy cooked, he would manage the place. During peak hours, he would help the staff. The staff they had inherited included a dishwasher, a full-time waitress, and a part-time waitress who came in during the evenings.

Ed and Nancy were also prepared to live on a small income until the restaurant became profitable. Somehow those profits were never realized.

The numerous customers they had expected coming in at all hours never materialized. During lunch hours they were lucky if they filled all the seats once. Ed realized that people were going to the competition down the street. Maybe the location of Ed and Nancy's restaurant was the reason? The only parking available for their customers was at the post office next door and that lot was closed after six in the evening.

When they took over the restaurant, Ed and Nancy assumed they could sublease the premises. However, the landlord had his lawyer draw up a new lease and they had to sign at a higher rent.

Within the first three months, the freezer had to be replaced and they discovered that their kitchen needed new plumbing. Fire inspectors came through on a routine inspection and told Ed the kitchen needed rewiring immediately. The landlord said he would not pay. After reading the lease, Nancy discovered that they were responsible for such repairs.

A few days ago, their senior waitress left for higher wages at a nearby restaurant. Ed was sorry to see her go because she was very popular with customers. He had never thought of the possibility that she might leave. But what could he do? He had asked her to wait another six months until he had more money. She said no and walked out.

Ed was also upset because his suppliers demanded that he pay C.O.D. They told him that they would consider credit when he had established a good credit rating.

More than once, Ed had difficulties with his staff. He thought that, since he had been a waiter once, he would understand their problems. Now, he was on the other side of the fence and the problems looked different.

Nancy was happy except that she found that cooking for friends is a lot different from cooking morning to night for other people. She discovered that, in the restaurant business, volume counts as much as quality, and that cooking is hard work.

She often ran out of staples when cooking. Twice, they had to cancel the daily special halfway through lunch. A number of times, they misjudged evening meals and they had food left over. This upset Nancy because of the hard work she had put into preparing those meals.

Yesterday, Ed and the dishwasher had another collision. Ed wondered where the dishwashing facilities should really be, near the counter or in the kitchen? Another location problem was the placement of the cash register. When Ed stood at the cash register, he was too far away to help at the counter. Yet often, when he was busy at the counter a line-up would occur at the cash register.

In the evenings after closing, Ed and Nancy were exhausted. Their day was not over yet. They had to clean the place; the cash had to be counted, and the next day's specials chosen.

"You know, Nancy," said Ed one evening as they were cleaning up. "We're discovering that there is more to owning a restaurant than we thought."

It is too bad Ed and Nancy did not realize what they were getting themselves into. There are many questions they should have asked themselves before making the decision to go into the restaurant business. Here are some of them:

- Am I willing to work hard?
- Am I willing to accept long working hours?
- Am I prepared to go into the restaurant business without a guarantee of profitability?
- Do I have the desire to succeed?
- Have I previously worked in a restaurant like the one I want to start or buy?
- Do I know enough about food preparation and food handling to direct people?
- Do I have the ability to do almost everything within the restaurant, from waiting on tables and performing minor repairs, to taking inventory?

- Do I have common business sense?
- Do I know what it takes to be a manager?
- Do I get along well with people, both employees and customers?
- Do I have the support of my family?
- Do I have enough personal savings or credit to buy and run a restaurant?
- Am I a good planner?

## CHOOSING YOUR TYPE OF RESTAURANT

In order to seriously consider going into the restaurant business, you must have a good idea of what type of restaurant is best for you. While types of restaurant operations can be difficult to classify, we list below some common terms that are used to describe different restaurants.

**Gourmet** Small and intimate surroundings provide an appropriate atmosphere for the expensive and specialized meals characteristic of gourmet restaurants. This type of restaurant is interested in promoting high standards and establishing a reputation which draws customers back and back again. The chef and the staff are usually highly trained and are noted for giving personalized service. Capital investment is usually high because of the elaborately decorated interiors. Less turnover for meal sittings is required because of higher meal prices. A good selection of liquor, beer, and wine is offered. These restaurants cater mainly to the evening trade, but many are now open during lunch hours and offer a different lower priced menu. Location can be in out-of-the-way places as customers usually search out this kind of establishment.

**Family** A large menu selection with a medium price range is offered by family style restaurants. Choice of liquor is usually limited to beer and wine. Investment can be medium to high according to the type of decor chosen. Counters, booths, and tables are usually found in this type of establishment which is often large and brightly decorated. Plenty of parking is available for family restaurants which are conveniently located in residential areas or near highways. The good location also contributes to the high volume needed in this type of operation. Hours are normally 7 a.m. to midnight. Staff is not as highly qualified as in gourmet restaurants. Reputation draws clientele.

**Coffee shop** Short orders and a quick turnover best characterize the coffee shop. Investment is not high as decor is usually limited. Not many comforts are offered to customers. Seating is limited to counters, and a few tables and chairs, and booths. Employees are not highly trained. The right location in high population areas such as office buildings is the key for the needed high turnover. However, rent can be high. A qualified chef is not required to produce the soup and sandwiches menu. Hot meals are also offered. Prices are generally low. A large portion of the business is in take-out during the morning, at coffee time, and at lunch time. Hours are usually 7 a.m. to midnight.

**Cafeteria** Because a large area is required to set up a cafeteria, the initial capital investment can be very high. Location is important for the heavy volume needed to support this type of operation. Large office buildings or shopping complexes are considered suitable. Emphasis is on self-serve. The menu includes prepared cold foods, desserts, and drinks. Hot foods, as a choice of two or three main courses, are usually served by a staff member. A large kitchen staff, not necessarily highly trained, is required to prepare the food. Beer and wine may be offered. A good layout is important in cafeterias so that customers move in and out quickly. Hours are normally 8 a.m. to 6 p.m.

**Deli-service** Volume is also very important for the deli-shop which is usually located in high traffic areas. Shopping malls, office buildings, and space near large companies are good locations. The limited take-out menu is low to medium priced. Some deli-shops may have a few seats available for customers. Hours are generally limited to office hours, 7 a.m. to 5 p.m. Foods are normally prepared beforehand, although sandwiches are often made as they are ordered. Capital investment is small. Labour costs also run low as only a few people, not highly trained, are required to handle customers.

**Ethnic** Specific foods from one country are the appeal of ethnic style restaurants. Decor usually fits into the theme of the restaurant. Staff can be from the specific country as well. Authenticity in food and service is important. Ethnic restaurants are close to gourmet as far as higher priced meals and the range of liquor available are concerned. Staff is well-trained and the cook is knowledgeable about food from the chosen country. Capital investment is high as the decor is usually elaborate. Location is central. Hours are 5 p.m. until 11 p.m., but many ethnic eating places are open at noon and offer special lower priced menus.

**Institutional** In-company feeding is a fast turnover cafeteria catering only to company employees. The hours are that of the company with the exception of catering for specific meetings or parties. A small investment is required as the utilities, rent, and the majority of equipment needed are usually furnished by the company itself. The cafeteria is offered as an employee benefit. Usually, only experienced restaurateurs are able to obtain this type of contract which is governed by the operator's ability to conform to contract specifications. These specifications might include good relations with the company's employees and consistently high quality food. Meal prices are low, and there are few operating expenses when compared to a public cafeteria of the same size.

**Fast-food chains** Another type of popular restaurant selling quickly prepared foods are the large fast-food chains. This type of operation is usually franchised. (See chapter I.) The limited menu is medium priced and mainly take-out in disposable containers. Residential areas provide the high volume needed for fast-food chains which usually open from 11 a.m. to 11 p.m., seven days a week. Help required is minimal and the staff need not be highly trained. Seating is limited. Investment varies according to the type of franchise you buy. When buying a franchise, the franchisor usually specifies decor, menu, type and quality of food, suppliers, equipment, and prices. It is advisable to carefully study all aspects of buying a franchise.

**Buffet** These total self-serve restaurants offer an easy way to eat, comparable to the family style restaurants. Staff is limited to a cook, a cashier and, probably, a meat cutter for the hot food service. The inexpensive decor provides a warm atmosphere, and the seating is comfortable. The buffet, with a variety of hot and cold foods, is usually one-price. Repeat servings are permitted. Hours of operation are 11 a.m. to 11 p.m. for this type of restaurant located in residential or downtown areas. Catering and banquet facilities are often offered.

## WHAT TO LOOK FOR WHEN BUYING OR STARTING A RESTAURANT

You have decided the restaurant business is for you, and have chosen the type of restaurant you wish to operate. But now you must look at what to consider when buying or starting a restaurant. This means planning. If planning is done carefully and thoughtfully, your entire operation will go more smoothly. What may seem like a waste of time in analyzing and agreeing on details will often turn out to be your most productive time. With good planning, you will better your chances of coming up with the right plan and the right design when starting a restaurant. You will better your chances of getting the best deal when buying a restaurant. Do not make the mistake of thinking that your restaurant is not large enough to need planning. Planning that saves time and money translates itself into profits.

Before you begin, it would be wise to visit several successful establishments of the type you want to buy or start. Go inside, have a cup of coffee or a meal and observe the operation. You can also ask questions.

One of the biggest advantages of buying an existing restaurant is that you are in business right away. Your location, menu, and clientele are established. You will likely have experienced staff who are familiar with the operation. Because you are purchasing the total business, you must analyze and understand all aspects of the operation. It is important to find out the owner's reputation as a business person; was he or she a good credit risk? Know the value of everything you have purchased, from the inventory to the equipment.

There may be some things you do not like about buying a restaurant. The decor may be old-fashioned, and a poorly-designed layout may be the cause of employees constantly getting in each other's way. Decor and layout problems can be solved, but it will involve the cost of renovations. Obtaining financing for work such as renovations may be easier for the buyer of an established restaurant because assessment can be based on proven past performance of the business. Buying a restaurant with a poor reputation requires some caution. Lending institutions may not look favourably upon the purchase of such a restaurant. It may take years before you can establish a new reputation for the business and bring back customers, even with a carefully planned effort.

Starting a restaurant, on the other hand, means beginning from scratch. You will plan the entire operation, open it up, and still not be assured of success. No one can guarantee that you will get the required volume. Good planning and preparation can lessen the uncertainty involved in opening a new restaurant. You will need to study the restaurant market and to carefully choose a location where you will reach the right kind of customers.

Whether you choose a menu of easy-to-prepare, small meals or gourmet meals, depends upon your type of restaurant. Decor is also determined by the type of restaurant and your budget. Obtaining financing when starting a new restaurant can be difficult. The advantage is that you can develop your restaurant into the kind of operation you want.

Buying or starting a restaurant involves research into the business beforehand. You will want to know exactly what you are getting into. Some of the elements to look at are potential **market, location, building, menu, equipment, layout, size, staff, and food and liquor inventory.**

**Market** Knowing your market thoroughly is a must in the restaurant business. To get a good idea of who your customers will be when starting, prepare a breakdown of the kind of people you want to serve: shoppers, office workers, men, women, or teenagers. If you are buying a restaurant, prepare a similar breakdown of people now patronizing the place. Include, in your breakdown, where these people work and live.

In starting a restaurant, check whether or not there is room for another restaurant like the one you want. Is the market already saturated? Check trends in the restaurant business, and economic trends. Are people eating in restaurants? Where? Do they eat out in the evenings as well as at lunch? Do people have the money to spend on eating out?

When buying, find out the real reason why the owner of the restaurant is selling. It could be because business has not been good in the past year. Maybe the bulk of the restaurant's customers, who used to come in for a three-course noon meal, now prefer to eat at a new fast-food take-out place down the street.

**Location** When choosing a location for your restaurant, you must know if the right type of customers are nearby. There are several ways to find out if there are enough people, either working or living in the area, who would want the kind of meals you will be offering.

If you want to open a cafeteria for breakfast and lunch, stand outside the location and try to count the number of people who walk or drive past in the morning and afternoon. Then try to find out where they go for breakfast and lunch, and also where other potential customers might come from. You could probably gather helpful population statistics from your local town or city planning department as well as the Chamber of Commerce.

Check to see if there is sufficient parking nearby and if public transportation is easily accessible to and from your restaurant. You might want to find out how efficient the garbage removal is in your chosen location; if it is easy to get the proper supplies; if the water system is good.

The type of restaurant you choose will also determine its location. A deli-service or coffee shop which depends upon high volumes would not normally be located in a residential area. Nor is it likely that a gourmet restaurant would be set up in a shopping centre which closes down at 6 p.m. Choose your location carefully and near the kind of people you want to serve.

Walk around the district where your restaurant is or will be. Check your competition. Evaluate their good points and bad points against your proposed operation. You must have some advantage over your competitors so that you will draw customers to your establishment. Your competitive advantage could be your friendly service, home-made items, unique decor, or maybe your own innovative ideas and personality. Find out how many there are and if they are doing well. If other businesses in the area are closing down, it may be a sign that the district is on the down turn. Also, find out if there are any plans for development or redevelopment in your area. You would certainly want to know if that huge office building one block away from your coffee shop was coming down in six months. The important thing is to search for information until you know the location well. As well as liking the location, you should feel secure that you could make a good profit in that spot.

**Building** If you have the money, you may wish to buy or build your own restaurant. Foodservice operators, however, usually lease. People open restaurants in a variety of places from converted barns and ships to premises in luxury high-rise buildings. The building can be unusual but it is important that it be suitable to house your type of restaurant, especially with the considerations of market and location.

The premises for a restaurant should be at street level for easy access. More importantly, is it visible and well-marked? A clean, distinctive and colourful illuminated sign, or a sign suited to your decor, will make your restaurant easy to spot.

The variety of building, safety, and health regulations make it difficult for a layman to check and comply with them all. It should be emphasized that all regulations need to be checked. If you do not ensure that your restaurant meets the necessary regulations when starting a new operation, it can be very expensive to renovate your premises after the restaurant is open. Similarly when buying a restaurant, check that the restaurant meets the required regulations. You may discover that the building does not meet the proper fire standards, for example. If the cost for renovations to meet these fire standards is very high, this could affect the selling price of the restaurant. Know what it will cost you to bring the restaurant up to the standards required. It might be advisable to hire the services of an architect, lawyer, or notary to help you.

An architect, for example, can not only help you with decor but can also check out your building. Whether buying or starting a restaurant, a qualified professional will make sure that your location meets:

- local building codes
- safety and fire regulations
- provincial and federal regulations, if any
- emergency requirements
- handicap requirements
- parking according to seating

You should also seek professional advice as to where to go for the necessary licences and permits.

In the case of buying a restaurant, a lawyer or notary will check if the business is free and clear of title. They can also help you understand your lease. You should know whether the premises can be taken over

on a sublease or if it is necessary to draw up a new agreement, which could be at a higher rent. Some leases contain clauses which give the landlord (over and above the rent) a percentage of sales as an additional fee.

**Menu** Your menu is the first thing a customer studies when he enters your restaurant. It is the link between you and your customers. It tells them what you have to offer and for how much. It can also give them the right or wrong impression. If your menu is a tacky, frayed, and stained piece of cardboard, a customer might get the impression that the food is prepared as sloppily as it is presented in the menu.

A good menu can be a tremendous selling device if it is clean, nicely presented, and with well-written descriptions of your meals. The type should be easy to read. The items you will be offering in your menu should be selected to your customers' tastes. Know your customers and what they like to eat.

It is difficult to try to write your menu in advance, but a basic menu is essential before any planning of a new operation can begin. Menus influence all aspects of your overall plan. When starting a restaurant, do not be overly ambitious and put too many items on the menu. List the meals that you can easily handle in the beginning and add to your menu as business increases.

When buying a restaurant, check what sells and what does not before changing anything on the menu. You could chase away loyal customers if you suddenly replace their favourite dishes with something else.

**Equipment** While it is not necessary to buy the most expensive equipment, you should try to buy the best you can afford. Leasing is an alternative when trying to limit initial cash outlay. Maintenance on secondhand equipment could catch up with you and you may end up replacing that equipment sooner than planned.

Whether you are buying or starting a restaurant, it is important to have only the equipment you will need. It is a waste of money to have the most expensive microwave oven if your meals are prepared from scratch. Restaurant equipment is expensive and it depreciates quickly, just like your family car. It would be a shame if you have to sell that microwave oven because of nonuse, and get back only a fraction of the cost.

Types of restaurants naturally influence the kind of equipment you will need. When buying equipment or evaluating equipment in a restaurant, you should consider:

- menu
- food preparation methods — will preparation be from scratch, partial or full convenience cooking
- hours and days of food preparation
- type of people to be served
- staff needed — also how qualified
- projected sales volume (in \$ or people)
- budget

When planning or evaluating storage facilities, make sure that they are adequate to handle your requirements. The amount of storage space you will need is dependent on many of the above-mentioned items. As an example, a restaurant using convenience foods, such as frozen and prepared foods, will have a much simpler storage facility than one preparing meals from scratch.

There are three types of storage areas: the dry store-room, the freezer, and the refrigerator. An orderly system of storage will help you keep track of your inventory. A loose storage system invites abuses of food supplies by employees.

Because the range of equipment available is so extensive and costly, it is advisable to have an architect experienced in the food industry, or a foodservice designer, help you select the right equipment. These professionals will match your equipment and decor to the type of food you are serving and to your budget. In the case of buying a restaurant get a qualified opinion on the condition of the equipment in the restaurant, and on whether or not it is suitable for the type of restaurant you want. Whether buying or starting a restaurant, professional advice on equipment will save you money and a lot of anguish from costly mistakes.

**Layout** Good facility planning and layout are a must for all types of foodservice operations. Layout plays an important role in establishing and maintaining a successful venture. Layout will set the tone of your operation, conveying a mood of spaciousness, intimacy, or fast-pace.

The primary point to remember is that the entire operation should be geared to provide the customer with a meal quickly and efficiently. The process of getting food from the kitchen to the customer must be smooth and uncomplicated. Poorly planned kitchens may produce a facility that is too large and over-equipped, or one that is too small to accommodate the proper equipment. An efficient kitchen produces more with less cost and effort. What you do not want to happen are bottlenecks and cross-traffic patterns. For example: a bad layout can cause serious congestion when the cash register, a small service stand for cutlery and coffee, and the only door to the kitchen are all together in only a small space.

By observing the day-to-day operation before buying a restaurant, you could probably spot layout problems if they exist. You can ask the employees if they have any complaints about the time it takes for the food to come from the kitchen and then to the customer.

An efficient and productive operation eliminates wasted space; has a good flow of work, product, and people, and is designed for greater employee and customer comfort.

**Size** Types of restaurants usually determine their size. A family restaurant will normally be larger than a gourmet restaurant. A deli-shop may be the smallest with only enough room for cooking facilities, a take-out counter, and a few seats. Seating in most restaurants is usually an important factor when considering size. Space allocation for kitchen, washrooms, bar, etc., goes by the number of seats in a restaurant. Most restaurants need a pre-determined number of seats, otherwise they would not reach the sales required to cover costs and to provide a profit. Of course, the financing you have available will also dictate the size of your restaurant.

Seating is calculated by the turnover required to meet projected sales figures. For example, suppose you need a daily average total dinner sales of \$1,000. Take an average check per person estimated at \$5.00, and with two turnovers, you know you must seat at least 100 people. Since it is impossible to fill every chair twice, you should figure on a higher number of seats (approximately 135). It is necessary to compensate for one customer sitting at a table for two, or for two customers being seated at a table for four. The rule of thumb for figuring out seat-

ing space in licensed premises is 12 square feet per person, which includes aisle and table and chair space. (Seating requirements may vary in some provinces and they should be checked.)

Example: 12 square feet  $\times$  135 seats = 1,620 square feet of  
seating space required

The type of seating you choose of course depends upon the design and type of restaurant. Customers can be seated in many ways: at counters, booths, high-top tables, and stools, banquet tables, and tables for two, four, or more. Seating arrangements are also planned to improve seating efficiency. Insufficient seating in an existing restaurant can be corrected by changing or rearranging the type of seating as advised by an experienced architect.

**Staff** The number of employees you will need for your restaurant depends on the type and size of restaurant you have. A 200-seat cafeteria will naturally require a larger staff than a 50-seat coffee shop. The qualifications of your staff will depend on your type of operation. Some restaurants require a highly qualified chef, waiter or waitress, and other kitchen help, while others only need people who can do the job well. Whatever your needs, there usually are foodservice industry schools, bartending schools, and employment agencies that can help you find the people you want.

On-the-job training should not be overlooked. Inexperienced employees can be trained on the job with your help, and with the help of trained personnel. Staff with experience in other restaurants can adapt to your restaurant with your guidance.

Buying a restaurant does not include buying the staff. It is a good idea to find out if any are willing to stay on, or if you want them to stay on. Some may be so identified with the previous owner that they plan to leave when you take over. In any case, you will have to establish a new relationship between the employees and yourself. The staff can often help you to become familiar with the operation by introducing you to customers and suppliers. They can help you keep up the routine of the restaurant without disrupting service.

Practising good employee relations is essential in the restaurant business. Treat employees fairly and honestly; give them recognition for their efforts. Let them know exactly what their jobs are and provide indi-

vidual job descriptions. An employee who feels part of a team will work harder and with a sense of purpose. Remember, the work habits of your employees will reflect the image of your restaurant. Waiters and waitresses are the contact between your restaurant and your customers. The quality of service they offer will determine whether or not customers come back.

**Food and liquor inventory** When buying a restaurant, you usually buy the inventory as well. Once you have agreed on a price for the restaurant, work out a separate agreement for taking over the inventory (food and liquor) at cost. Do not agree to a package deal. The inventory may have been priced too high and you may pay more than what the stock is really worth.

Check the inventory to see if it consists of what you will need. Make sure that the stock is not out-of-date. It may even be that you have paid for stock that is not there or for which the supplier has not been paid. Set a date as close as possible to the closing date of the sale for takeover of the stock. Remember that if the owner is using up the inventory before you come in, the inventory will be less.

If starting a restaurant, your food and liquor inventory must not be overly ambitious. Your inventory, especially as regards food, must bear a very close relationship to your menu. You do not want to run out of staples and yet, at the same time, do not wish to be overstocked.

When starting a restaurant, as well as when buying one, you will have to set up efficient controls over your food and liquor inventory. Remember that your inventory, unlike that of a retailer, is highly susceptible to spoilage and waste. Proper inventory control will help reduce this risk.

## ASSESSING THE PROFITABILITY

Before buying an established restaurant or starting a new one, the most important aspect to examine is the potential profitability. In other words, you want to know if you can “make a go” of your restaurant. It is better to learn before you begin that your operation is not financially feasible than to learn the same information when you are standing

behind the counter as the new owner. And if your study shows that you can be successful, your assessment will then be your initial operating guide.

Of course, there are many factors that will affect your assessment. The size and type of restaurant you want will have considerable bearing on your financial picture both as to commitment and to possible return on investment. Even the factor of starting from scratch compared to buying an existing restaurant could make a difference. In starting your own restaurant, you may be able to develop at a slower pace more in keeping with your finances. On the other hand, while buying an existing restaurant will mean immediate sales, you may be making a larger financial commitment as well as paying for goodwill, which may or may not exist.

Other factors that will affect your assessment include the possible need for renovation or remodeling. Converting a retail shop into a restaurant can often be quite expensive. Also, whether or not you buy or lease your premises can make a considerable difference in your costs.

## **i Assessing the established restaurant**

If considering the purchase of an existing restaurant, your assessment of profitability is usually easier than when starting from scratch. This is because there are existing assets such as equipment, fixtures, and inventory to evaluate and because there is a proven business history supported, it is to be hoped, by records. Also there will be suppliers, accountants, staff, credit reporting agencies, and similar services that you can consult concerning the established restaurant.

An important part of assessing an existing restaurant is to evaluate the asking price by determining the value of the assets. The difference between their dollar value and the total selling price can be considered as goodwill or the seller's profit. The market value of what you are buying should be stressed and compared to the goodwill. If the asking price is \$50,000 and the assets are only worth \$35,000, you must be sure that you can recover this difference if you resell the restaurant. When operating the business, the return on investment must be calculated on the total price not just on the assets. To evaluate the assets, estimate a replacement value and a price on how much would be realized on a forced sale. This can give you a good idea of the market value.

In assessing an existing restaurant, you should also speak to people connected with the business. This includes suppliers (to check if accounts are paid when due and if the owner is a good buyer or an erratic buyer), the owner's banker (for as much information as possible), credit reporting agencies (credit rating and history), and the restaurant's employees.

The most important tool to help you assess the restaurant's profitability is, of course, the existing financial records. The balance sheets and profit and loss statements (preferably audited) for at least the last three years should be closely examined. If the statements are not up-to-date, you should insist that the owner prepare a profit and loss statement for the last six months. If records are inadequate, or said not to be available, for whatever reason, the buyer should be particularly cautious in assessing the business.

It is important to stress, at this stage, that you obtain for yourself the services of a professional accountant to analyze the financial situation of the existing restaurant. Your accountant should also prepare, with your assistance, a forecast (along with a cash flow statement) for the first year you would own the restaurant. To give you an indication of the longer term, it is advisable that your forecast be prepared not only for the first year but also for the following two or three years.

This professionally prepared forecast is a must. For, unlike the vendor, you will more than likely have to carry a debtload if you are financing the purchase of the restaurant. Even if the vendor had originally financed the purchase of the restaurant, your interest rates and the amount of your loan will more than likely not be the same. Also, your requirements for a profit may be completely different. The vendor may have been satisfied with a 15% return but if you have large personal commitments such as family, home mortgage, or consumer debts, you may need a larger profit. A forecast will show whether or not you can afford to operate such a restaurant.

Before examining a typical profit and loss forecast for a restaurant, let us look at some aspects of assessing a restaurant that you are starting from scratch.

## ii Assessing the start-up of a restaurant

Unlike the established restaurant, the restaurant being started from scratch has no past records to be used as reference points. It is important that your estimates of sales, expenses, and profits be as accurate as possible. Another major difference between starting a new operation and buying an existing one is that instead of making basically one payment for a total package, you are making a number of purchases which in total constitute your restaurant. It is therefore necessary that you determine exactly what your requirements will be and what the costs will be.

**Your starting costs will usually consist of the following items:**

### **Capital expenditures**

- kitchen equipment
- bar equipment
- small wares such as dishes, cutlery, kitchen utensils, linens, and uniforms
- leasehold improvements, (electrical, plumbing)
- decorating or renovation costs
- tables and chairs or booths, counters
- cash register

### **Opening costs**

- lease deposit
- licences
- start-up costs for electricity, gas, and telephone
- insurance
- accounting and legal fees
- accounting system
- architect's and designer's fees
- printing expenses for menus, stationery, accounting, and office forms
- advertising and publicity
- taxes
- wages (staff may be needed before opening)

### **Inventory**

- food stock
- liquor stock

### **Contingencies**

- unplanned expenses always arise — allow 10% to 20% of planned expenses

### **Reserve fund**

- 2 to 3 months minimum of overhead costs and salaries to cover the possible lack of cash flow during initial period. (Depending on your type of restaurant, you may require a larger reserve or a smaller one.)

The above costs reflect the situation of a new restaurant in leased premises. They do not consider the purchase of a building and its related costs. Also, the equipment and furniture are shown as purchases requiring a cash outlay; leasing is another alternative. When trying to limit your initial cash outlay, leasing — monthly payments — might be preferable to an outright purchase. Another point to consider is that, initially, until you have proven yourself, your food and beverage suppliers may insist that all inventory purchases be on a C.O.D. or deposit basis.

Similar to the situation of buying an existing restaurant, you will require the services of a professional accountant to assess the profitability of the venture. A forecast along with a cash flow statement for the first proposed year should be prepared. To assess the longer term, it is again advisable to prepare your forecast not only for the first year but also for the following two or three years. This is required in determining your financial needs, especially in the calculation of operating expenses, and a reserve fund. A realistic assessment of sales, expenses, and profit will allow you to determine if the venture is financially feasible for you.

## **FORECASTING THE PROFITABILITY**

For both the existing business and the start-up situation, we show a typical (as far as this is possible) profit and loss forecast for a small family type restaurant. The period covered is for the first three months. Ideally, such a forecast is done on a quarterly, or even monthly, basis. This can be advantageous in seeing where "lean" periods may occur.

# Forecast Profit and Loss For the 3-month period beginning June 1st

	\$	%
Food Sales	22,875	100
Cost of Food	<u>9,150</u>	<u>40</u>
Gross Profit (Food)	<u>13,725</u>	<u>60</u>
Liquor Sales	8,437	100
Cost of Liquor	<u>2,531</u>	<u>30</u>
Gross Profit (Liquor)	<u>5,906</u>	<u>70</u>
Total Sales	31,312	100
Total Food and Liquor Costs	<u>11,681</u>	<u>37</u>
Gross Profit	19,631	63
Operating Expenses:		
Wages	8,454	27
Fringe Benefits	1,014	3
Rent	3,200	10
Electricity and Gas	590	2
Water	—	—
Laundry	325	1
Insurance	178	1
Delivery Truck	400	1
Maintenance and Repairs	200	1
Paper Costs	175	—
Advertising	600	2
Term Loan Interest	225	1
Depreciation	180	1
Telephone	<u>115</u>	<u>—</u>
Total Operating Expenses	<u>15,656</u>	<u>50</u>
Operating Income or (Loss)	<u><u>3,975</u></u>	<u><u>13</u></u>

**Note:** The previous figures and percentages for the forecast are presented only as an example. They do not constitute an operating guide. Published figures are available on many types of restaurants. Check with your local restaurant association or your accountant.

Let us look briefly at our forecast. Sales have been divided between food and liquor as these two commodities must be treated as two separate profit and cost centres. The total sales, based on the most realistic projections possible, show that there is sufficient volume to cover operating expenses and to provide a profit. If the operating income shown is insufficient, you have three choices: either sales volume must be increased or, through careful analysis, expenses must be reduced, or gross margin increased if the market permits. Any increase in sales must be realistically attainable and any cutback in expenses must not affect your ability to operate and to generate sales.

It is important to work out your forecast in percentages as we have done. There are many published statistics and national averages which will allow you to compare your operation to the norm. For example, you might find that your liquor costs are too high in relation to sales or that certain operating expenses are not in line. Your forecast then becomes a measuring stick. Comparing your actuals to your forecast by percentages will also be a ready indicator of your performance and will highlight any trouble spots in your restaurant operation.

In conjunction with the above forecast, a cash flow statement should be prepared for the same period of time. The purpose of the cash flow statement is to show you, on a month to month basis, what cash you estimate to receive, what cash you will have to pay out, and where you may have cash surpluses or shortages.

Assessing the profitability of your venture, be it the start-up of a restaurant or the purchase of an existing restaurant, is a requirement not only for yourself but also for a lender. For if your venture proves to be viable and you need term financing, a lender will want to see your assessment.

**The following table briefly outlines the pros and cons of starting a new restaurant or buying an existing one.**

**Starting a new restaurant**

- as everything new and unproven, must analyze all aspects of business venture
- slow start-up time
- no assurance you will get required volume — risk and
- choose your own location
- develop your own style of doing business — no restrictions on image, menu or service; design interior of restaurant your way
- financing can be difficult
- initial outlay of cash before operating
- must find and train staff
- find suppliers and establish line of credit
- develop at your own rate

**Buying an existing restaurant**

- purchasing total business, must analyze all aspects of the business — there may be a good-will charge
- in business right away
- established clientele, proven business history
- location may be good or bad, must analyze
- accept decor and layout of restaurant — changing it requires money for renovations; menu and service may take longer to change
- financing easier when based on proven performance
- as in business right away, money (sales) coming in
- experienced staff familiar with your operation — owner can also pass on information about the business to you
- lines of credit and supply established with suppliers
- must keep or increase business' tempo

## CHECKLIST

This section consists of a checklist for you to complete. Some of the questions have been examined in the chapter, while other questions are there as an inducement to enquire further into the aspects of buying or starting a restaurant. You may also wish to use this checklist as a guide when contemplating the ownership of a restaurant.

### QUESTIONS

	YES	NO
<b>YOU AS A RESTAURATEUR:</b>		
Are you willing to work long hours and to work hard?	<input type="checkbox"/>	<input type="checkbox"/>
Are you prepared to go into the business without a guarantee of success?	<input type="checkbox"/>	<input type="checkbox"/>
Have you worked in a restaurant like the one you want?	<input type="checkbox"/>	<input type="checkbox"/>
If you have little or no restaurant experience, are you willing to work in one for at least six months to a year?	<input type="checkbox"/>	<input type="checkbox"/>
Are you familiar with food preparation and handling?	<input type="checkbox"/>	<input type="checkbox"/>
Have you had any business training?	<input type="checkbox"/>	<input type="checkbox"/>
Do you get along well with people?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have savings and a good credit rating?	<input type="checkbox"/>	<input type="checkbox"/>
Does your family support your idea of going into the restaurant business?	<input type="checkbox"/>	<input type="checkbox"/>
<b>CHOOSING YOUR RESTAURANT:</b>		
Can you list the different types of restaurants?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what a gourmet restaurant is?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the difference between a family restaurant and a coffee shop?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you know the difference between a cafeteria and a deli-service?	<input type="checkbox"/>	<input type="checkbox"/>
Can you describe an ethnic restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Can you describe institutional restaurants?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what fast-food chains and buffet restaurants are?	<input type="checkbox"/>	<input type="checkbox"/>

### **WHAT TO LOOK FOR WHEN BUYING OR STARTING A RESTAURANT:**

Are you aware of the advantages and disadvantages of buying a restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the advantages and disadvantages of starting a new restaurant?	<input type="checkbox"/>	<input type="checkbox"/>

#### **Market:**

Have you researched your market?	<input type="checkbox"/>	<input type="checkbox"/>
Have you visited the kind of restaurant you want?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know who your customers will be?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where your customers will come from?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if the number of people eating in restaurants is increasing or declining?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how much money people are willing to spend on eating out?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the real reason why the owner is selling his or her restaurant?	<input type="checkbox"/>	<input type="checkbox"/>

#### **Location:**

Have you analyzed your location thoroughly?	<input type="checkbox"/>	<input type="checkbox"/>
Do you like the location and is it a good one?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the type of people living or working nearby?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Will these people go to your type of restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if there would be enough customers to support your restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Have you found out where customers eat now?	<input type="checkbox"/>	<input type="checkbox"/>
Is your location easy to get to?	<input type="checkbox"/>	<input type="checkbox"/>
Is there sufficient parking nearby?	<input type="checkbox"/>	<input type="checkbox"/>
Have you analyzed your competition?	<input type="checkbox"/>	<input type="checkbox"/>
Is your business compatible with the surrounding area of your location?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of any plans for development or redevelopment in the area?	<input type="checkbox"/>	<input type="checkbox"/>

### **Building:**

Is the building suitable for your type of restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Will you have to make renovations?	<input type="checkbox"/>	<input type="checkbox"/>
Is it at street level?	<input type="checkbox"/>	<input type="checkbox"/>
Is your restaurant well marked and easy to spot?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the building regulations with which you must comply?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what the safety and health regulations are?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of what licences and permits you will need?	<input type="checkbox"/>	<input type="checkbox"/>
Are you sure you can meet the requirements to obtain a liquor licence?	<input type="checkbox"/>	<input type="checkbox"/>
Do you understand the terms of the lease?	<input type="checkbox"/>	<input type="checkbox"/>
Has a lawyer or notary helped you with your lease?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
<b>Menu:</b>		
Do you know what your customers will like to eat?	<input type="checkbox"/>	<input type="checkbox"/>
Have you decided on a basic menu?	<input type="checkbox"/>	<input type="checkbox"/>
Can you handle the items in your menu without difficulty?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what a good, well-presented menu looks like?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Equipment:</b>		
Do you know what equipment you <b>really</b> need?	<input type="checkbox"/>	<input type="checkbox"/>
If starting a restaurant, do you know the best sources for buying equipment?	<input type="checkbox"/>	<input type="checkbox"/>
If buying a restaurant, have you checked the condition of the equipment?	<input type="checkbox"/>	<input type="checkbox"/>
Have you thought about leasing equipment?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Layout:</b>		
Do you understand how a good layout will contribute to the efficiency of your operation?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Size:</b>		
Do you know what determines the size of a restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how seating is an important factor in determining size?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how proper seating arrangements contribute to profits?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked the different ways to seat customers?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Staff:</b>		
Have you figured out how many employees you will need?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Have you determined what their qualifications should be?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of minimum wages and labour regulations?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where to look for staff?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know why good employee relations are important?	<input type="checkbox"/>	<input type="checkbox"/>

### **Food and liquor inventory:**

If buying a restaurant, have you made a separate agreement for purchasing the inventory?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked the inventory as to content, cost, quantity, date of purchase, and condition?	<input type="checkbox"/>	<input type="checkbox"/>
If starting a restaurant, will you be careful not to overstock your initial inventory?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the need for efficient controls over your food and liquor inventory?	<input type="checkbox"/>	<input type="checkbox"/>

### **ASSESSING THE PROFITABILITY:**

If buying an established business, have you determined the value of the assets?	<input type="checkbox"/>	<input type="checkbox"/>
Have you compared the market value of the assets to the asking price?	<input type="checkbox"/>	<input type="checkbox"/>
Have you met with the owner's banker and suppliers?	<input type="checkbox"/>	<input type="checkbox"/>
Have you examined the financial statements of the established business?	<input type="checkbox"/>	<input type="checkbox"/>
Are these statements up-to-date, especially the profit and loss statement?	<input type="checkbox"/>	<input type="checkbox"/>
Have you engaged the services of a professional accountant?	<input type="checkbox"/>	<input type="checkbox"/>
Has this accountant prepared a forecast and cash flow for you?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Have you forecasted sales and costs realistically?	<input type="checkbox"/>	<input type="checkbox"/>
Have you allowed for unplanned expenses?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if buying a restaurant is financially feasible for you?	<input type="checkbox"/>	<input type="checkbox"/>
If starting a restaurant from scratch, do you know all your start-up costs?	<input type="checkbox"/>	<input type="checkbox"/>
Have you forecasted sales and costs realistically for your new restaurant?	<input type="checkbox"/>	<input type="checkbox"/>
Have you allowed for unplanned expenses?	<input type="checkbox"/>	<input type="checkbox"/>
Have you set aside a reserve fund for your first few months of operation?	<input type="checkbox"/>	<input type="checkbox"/>
Has a professional accountant prepared a forecast and a cash flow statement for you?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if starting a restaurant from scratch is financially feasible for you?	<input type="checkbox"/>	<input type="checkbox"/>

## CONCLUSION

Buying or starting a restaurant is not easy. A successful operation takes a lot of planning. Careful planning before you begin can make the difference between a well-respected restaurant that makes a profit and one that goes under after only a few years.

It is important that you, as a restaurateur, be suited to the business. It is also important to know and understand as much as you can about restaurants.

### 3. CONTROLS FOR YOUR RESTAURANT

*"Controls in your restaurant are just as important as the food you serve." — CASE Counsellor*

INTRODUCTION .....	54
WHAT ARE CONTROLS? .....	54
YOUR FIRST CONTROL: THE MENU .....	58
CONTROLS AS INFORMATION .....	62
CONTROLS AS A SYSTEM .....	71
BEVERAGE CONTROL .....	77
CONCLUSION .....	80

## INTRODUCTION

A restaurant without controls is like a professional hockey team which has not developed any game plans. The team plays together but does not know what to expect of its team mates. They may win games through sheer luck, but they will never win a championship.

The restaurateur who just trusts to luck and hopes business will succeed may easily end up with a losing proposition, or a business that fails. This person will not likely be the proud owner of an efficient, money-making operation.

In the past, food and labour were very inexpensive. Restaurateurs often left the success of their business to chance. This method often worked and the owners made money. In today's market, the high costs of food and labour mean restaurateurs cannot afford to forget about controls. They must know where their businesses stand, or they can almost expect to close their doors in the near future.

Good controls are based on planning your total restaurant operations, collecting accurate data on all aspects of your business, and using these data regularly. You may already have some controls. You may wonder why you need more or why you should try new ones. With good controls, you may discover you are able to make a lot more money than you had thought possible.

The purpose of this chapter is to examine various controls and to see how they can be used in your restaurant.

## WHAT ARE CONTROLS?

Control in your restaurant begins with knowing what happens in all aspects of your business. You should know whether your business is doing well or if it is losing money. By instituting controls and constantly monitoring them you can catch problems early or even before they occur. Discovering problems early or before they happen will enable you to correct the situation before your business is really hurt.

To get, and to keep, control of your restaurant requires the use of certain control procedures as well as your own personal observations.

**Control procedures are to be found in what your menu offers along with its prices, in the operating information that you gather, in the operating system that you have established, and in the monitoring and pricing of your beverages.**

Ed and Nancy discovered that controls were absolutely necessary to ensure the success of their restaurant. Let us look briefly at the controls that Ed and Nancy instituted in their restaurant.

After Ed and Nancy had owned their restaurant for a few months they decided that they could make a few changes to improve the business. The first thing they did was to shorten the menu. Their research had shown that their customers really liked only one-third of the items on the long, complicated menu set up by the previous owner. Ed and Nancy decided to eliminate the non-selling items and to reprint a new, shorter menu listing the most popular dishes.

Ed and Nancy advertised their daily specials by attaching a type-written sheet to the menu each day. Specials, especially at lunch hours, were very important to their business; they counted for most of the noon hour orders. Their customers wanted good food and fast service, in a reasonable price range. In order to keep this business, Ed and Nancy knew they had to charge between \$3.50 and \$4.00. They chose items for their luncheon specials accordingly — items that would fit into that price range and still give them the 35% of sales food cost that they were trying to maintain. When pricing other items on their menu, Ed and Nancy not only considered their clientele and the cost of food, but labour costs, style of service, and portions. Naturally the final price has to suit the customers, as well as Ed and Nancy. Calculating the right prices is only one of the many controls Ed and Nancy use to keep their restaurant running profitably.

Ed's day is usually taken up with managing the restaurant and by taking cash and helping the staff during peak hours. When business is quiet he sits down to tabulate how much food was sold in the restaurant for each meal period the previous day. Ed also fills out a menu breakdown form which tells him how much of each item is sold each day. From this information, Ed gets a pretty accurate estimate of how

much food to buy, how much food to cook for each meal, as well as the number of staff he will need for certain times of the day. The information will also show if the items on the menu are selling.

By keeping track of labour costs on a weekly basis, Ed knows whether or not their labour costs are too high. Ed and Nancy determined that for their restaurant the labour costs should not exceed 30% of sales. With the high cost of wages, Ed and Nancy cannot afford to let these costs get out of control.

At the end of each month, Ed carefully studies how the total business is doing. He prepares a monthly statement showing income and expenses and, as well, calculates his total food and labour costs. Ed always compares current costs against projected costs and those of previous months. If something is wrong, now is the time to do something about it. He also uses these monthly statements when it comes time to prepare the profit plan for next year.

Nancy is the chef, and is in charge of running the kitchen. She sets aside certain times of the week for purchasing. In order to maintain their high quality of food, Nancy purchases the food according to a specifications chart of her own design. She knows exactly the types of meats she wants and how they should be cut; the quantity and sizes of foods she is going to buy, and the quality. She also has a good idea of what prices she should be paying.

By drawing up such a specifications chart, Nancy knows that if she is unable to do the purchasing Ed will know what to buy. Both Ed and Nancy keep each other constantly informed about what is happening in their areas of responsibility. Sometimes Ed helps Nancy check the shipments of food to make sure they have received what was ordered and that the prices are right.

Nancy's responsibilities include taking charge of the storeroom and putting food away in the proper storage areas. With only Ed and Nancy holding the keys to the storeroom, they have had little food pilferage. Nancy's careful storage procedures also ensure that little food is wasted. When she issues food to her assistant, or herself, she keeps track of what goes out of the storeroom.

From the information Ed collects in the sales reports, Nancy and Ed work out how much food should be prepared for each meal. This helps control leftovers and also makes sure they have enough food available so as not to annoy good customers.

Nancy is meticulous in the kitchen. Her recipes are very carefully written and easily accessible. If her part-time assistant needs to read a recipe card he knows where to look for it. Nancy's assistant could easily take over in the kitchen by following the standardized recipe cards, and by following the production guide sheet on how much to make for each day.

Every evening after closing Ed and Nancy account for all their bills. Each morning Ed issues a certain quantity of pre-numbered bills to the senior server. The server is in turn responsible for the bills of the other servers. In order to avoid losing track of bills, Ed and Nancy decided to use a duplicate bill system. The duplicate is kept in the kitchen by Nancy and the original goes to the servers. Copies are matched and compared at the end of the day. If an original bill is missing, the copy will have the right information. Without such a system, a missing bill is next to impossible to trace. Did the bill get lost or did a customer walk out? Maybe someone pocketed the money? It is also difficult to tell if the amount was for a pie and coffee, or for a steak dinner.

The beverage operation in their restaurant also requires some close controls. Ed and Nancy offer a selection of wine, beer, and some liquors. Ed cannot always act as bartender, so he uses a separate set of pre-numbered bills for recording beverage sales. The servers are asked to present the bills to customers separately from the food bills. These bills are issued and counted each day, as well as being recorded in an inventory book. Ed also maintains a par stock. The liquor sold is calculated and depleted stock is replaced each evening.

Instituting and maintaining controls take a little extra time, but it is worth it. Ed and Nancy know that without their controls, they would easily lose track of what is happening in their restaurant.

## YOUR FIRST CONTROL: THE MENU

An important element in the style of business you decide upon for your restaurant includes your menu. There are several types of menus, from limited ones offering only three or four items to varied menus with as many as 50 items to choose from.

The best and most efficient menu for cost control purposes is a simple one with only a few items. You only have to look at the simple menus offered by the large and successful chain operations to see how true this can be. A large menu can affect the quality of the food because the owner may be trying to cook too many items. This in turn can affect the quality of service.

Once you have carefully chosen your menu, you will want to make sure each item is correctly priced. Your mark-up must be sufficient to cover costs and to help make a profit for your restaurant. It is also important that your prices be set at what customers are willing to pay. Prices that are too high could mean customers will only buy lower priced items on your menu, or they will switch to another restaurant.

There are several factors which help determine prices. Among those factors, the costs of food and of labour influence prices the most. Guidelines for cost of food are usually determined by the cost of food as a percentage of sales. There is no rule-of-thumb for restaurants as to what percentages should be used. A good method might be to find out what similar restaurants use as guidelines and then try to set your own. A 200-seat family restaurant, for example, might have a 35% food cost.

Established guidelines for the cost of labour are also non-existent. The percentage of sales you want to maintain depends upon your own restaurant. In the same 200-seat restaurant, you might want to set a labour cost of between 25% and 30%. It is important, however, to maintain a balance between food and labour costs. You could keep food and labour costs between 60% and 65% of sales. If food costs are high at 40%, then labour costs must be lower at 25%.

Restaurateurs use a variety of methods to price their menus. One of the most accurate and one of the most popular methods is to calculate the cost of all ingredients entering an item such as a hamburger, and to divide this total cost by the percentage food cost you want to maintain.

To calculate the cost of the ingredients in a hamburger, begin by listing how they are purchased (buns by the dozen), and the quantity. A purchase price is set for the volume ingredients (\$.75 for one dozen buns). A unit cost is calculated per bun, per gram, per slice, per leaf, and per pickle. Then a portion price is worked out:

$$\begin{aligned} &\$ .75 \text{ per dozen divided by } 12 \text{ buns} = \\ & .06 \text{ cents per bun} = \text{your cost per bun} \end{aligned}$$

Your cost of the hamburger could be calculated as follows:

\$ .06	bun
.25	meat pattie
.02	mustard
.02	relish
.03	lettuce
.04	tomato
<hr/>	
<u>.42</u>	

If you want to maintain a 35% food cost then your hamburger should be priced at \$1.20

$$\frac{.42 \times 100}{35} = \$1.20$$

We can also calculate the cost of a meal using the same method. Let us say you want to offer a luncheon which will include the main course prepared in the kitchen, and soup or salad and dessert from a self-service bar. (Because labour costs will be lower using partial self-service, you could afford to spend a few more cents on food. This gives you better food, quick service, and reasonable prices. If you were to have full dining room service, with four servers, your labour costs would be higher and the amount you could spend on food would be less.) You want to offer the lunch at \$3.95 to keep in competition with the going price for lunch, which is \$4.00. The items you choose to serve for the special will have to fit cost-wise into the area of \$3.95.

**For example:** To serve a meal for \$3.95

	\$	
Soup or salad bar	.50	Cost per portion
Dessert	.20	as you have
Beverage	<u>.15</u>	already worked
	<u>.85</u>	out

If you want to keep a maximum  
food cost at lunch of 35%, then  
35% of \$3.95 is

1.38	
<u>- .85</u>	already spent
<u>.53</u>	left for special entrée

Costing out the special entrée

Vegetable	.10
Potato	.10
Entrée	<u>.33</u>
	<u>.53</u>

Entrée could be low cost items such as chicken pot pie,  
chili, moussaka, or ham and cheese pie.

Most menus will have a variety of mark-ups as each item cannot have the same mark-up. Expensive items like steaks may be marked up only two times for a 50% food cost because your market will not take a high price. Another less expensive item may be marked up for a 33 1/3% food cost. The key is in balancing each item on your menu so that you maintain the average food cost you want. Your menu must have enough low cost items to offset those high cost items.

To figure out if you have a profitable balance in your menu, you must first know the cost per serving of each item you offer, and have accurate sales tallies on each item.

Example:	Cost	Sales	
50 steak dinners at \$4.00	\$100.00	\$200.00	50%
100 baked haddock at 2.00	<u>56.00</u>	<u>200.00</u>	<u>28%</u>
Average	156.00	400.00	39%

If you sell 50 steak dinners for \$4.00 with a 50% food cost, then you must sell 100 baked haddock dinners for \$2.00 yielding a 28% food cost. The average of these two will give you a 39% food cost. When making this calculation between all items on your menu, you may want to aim for 39% on all items, or you may have a range of between 35 and 40%.

In the course of checking your menu you may discover that customers are buying the number of steaks you projected. However, you are only selling half as much haddock as you should. Your food costs are now too high. You may have other low cost items on your menu which will offset the high cost of steaks, or you may have to replace the haddock with something which will sell better.

Food items for a basic dinner menu can be higher priced than those mentioned for a basic luncheon menu. You will want to maintain a higher average bill for the evening meals. In our 200-seat family restaurant, you might look for an average bill of between \$6 and \$8 on weekdays and between \$8 and \$10 on weekends. Food items which will fit into this price range are probably the less expensive steak items, fish, and poultry. In order not to lock yourself into this price range you could offer specials of more expensive foods such as lobster, and of less expensive foods such as stews.

As a review, some of the factors you should consider when pricing a menu are:

- cost of food
- quality of food
- size of portion
- cost of labour
- style of service
- competition
- atmosphere and decor
- clientele
- location

**Note:** Competitive pricing must be done only in those cases where comparable products are served, in comparable atmospheres, with comparable service. Two restaurants offering the same item may charge completely different amounts when other factors are considered.

By properly pricing your menu and by developing your style of service, you are setting the framework for controlling the two major expenses in a food operation: food and labour.

## CONTROLS AS INFORMATION

Establishing guidelines for your restaurant depends upon your style of business and on what your goals are. Before you can tell whether or not your restaurant is meeting its operating objectives you must have the right information from which to work. Gathering and analysing information on the various sales and labour costs can be used as a guard against runaway costs. If you discover that food costs are too high, then this information should be an indication for you to begin looking for possible problems. Information is meant to be looked at as often as possible — some information should be looked at daily and weekly, and some on a monthly basis. Reviewing your information gives you the opportunity to catch problems, and to do something about them before it is too late.

Your system of gathering information should be simple and practical. You should be able to do it yourself without spending an excessive

amount of time. You may also consider the purchase of a computerized cash register which will do some of the work for you. There are cash registers which will automatically record your sales, total bills, give individual item sales tallies at the end of each day, and do inventory control. It depends on what you want, and what you can afford.

The information you should plan to gather on your restaurant includes: a **daily sales report**, a **menu breakdown**, **weekly labour costs**, **monthly food costs**, a **profit and loss statement** and a **yearly profit plan**.

## Daily

**Daily Sales Report** Included in the information you need to know daily is a tabulation of sales in each area of your restaurant. This means recording the amount of food sold in the coffee shop, in the dining room, in the bar, etc. Break down the food sales into meal periods, i.e., how much was sold at breakfast, lunch, and dinner. You should include the number of customers for each meal period, and the average amount of each bill.

Studying your daily sales report is probably the best method of finding out if your sales are increasing or decreasing. If sales are decreasing, something is wrong and research is required to find the problem. If sales are increasing, you will have to be better prepared to handle more customers. Your daily sales report will help you to determine how many customers to expect, at what time of day, and on what day of the week. By knowing this information in advance, you will have a more accurate estimate of how much food to order and when, how much food to prepare and when, and if you will need extra staff. An accurate estimate of how much food to cook and when to cook it is an excellent way to help control wastage and to help maintain the proper food costs. Eliminating the guesswork can save you money. If you know from your sales reports that on Fridays you normally serve about 50 baked potatoes between 6 and 7 p.m., you will know to prepare 25 potatoes at 5 p.m. and 25 potatoes at 6 p.m. Not only are you helping to avoid wastage, but you are serving the freshly prepared foods customers want.

Maintaining a record of your sales will help you to project the number of servers you will need. You will know when your busiest hours are and when to bring in extra staff. You may want to have part-time help come in during peak hours only. Likewise, when business is slow you do not want to have to pay for extra help.

The amount of your average bill can tell you about the efficiency of your menu, and how customers react to your pricing. If you recently increased your prices and the average bill stays the same, it may mean your customers are switching to lower priced items on the menu. If this continues you may have to rethink your price increase and try to cut corners somewhere else. Conversely, if you discover that your average bill is between \$4 and \$6 instead of the \$6 to \$8 you need, this too may be a cause for concern. You may have to cut back on some services — such as a hostess or an extra server — until you can raise your average check.

Weather 20°C RAIN

**DAILY SALES REPORT** Date JULY 24 Day THURSDAY

	Food Sales	Liquor Sales	Total	No. Customers	Avg. Bill*	Sales Tax	Total
Lunch	\$630.00	\$35.00	\$665.00	150	\$4.20	\$48.00	
Dinner	468.00	33.00	501.00	72	6.50	46.80	
After 9 pm	94.50	27.00	121.50	18	5.25	8.50	
TOTAL	1192.50	95.00	1287.50	240		103.30	

\* food sales only

**Menu Breakdown** The information in your menu breakdown should be analysed in conjunction with your daily sales report. A menu breakdown will tell you how much of each item you are selling, and when you are selling it. When you see that an item is not selling well, that is the time to take it off your menu. Studying your menu breakdown, along with the other information you keep daily, is your best method of accurately projecting food orders and preparation quantities.

## Weekly

**Labour Costs** The labour costs for your restaurant are determined much like your food costs. They depend upon the style of service you offer as well as the kind of food you serve. A gourmet restaurant will usually maintain a higher cost of labour as a percentage of sales compared to a fast food operation. A gourmet restaurant offering personalized service to complement the food and the atmosphere may have labour costs as high as 35%. Costs in the fast food operation may be as low as 10% to 12%.

A family style restaurant may want to maintain an overall 25% labour cost, which might be broken down to 13% in the kitchen and 12% in the dining room. Each restaurateur must determine his or her own guidelines. Your goal will be to try to maintain that 25% labour cost each week.

If you find your costs are 35% instead of 25%, this should be an indication for you to correct the situation. You will probably have to analyse your operation and find out where the problem is. Maybe you are overstaffed. It could also be that you are spending too much on production costs in the kitchen. Your staff is spending a lot of time making bakery products from scratch. To cut their time and your costs, you could choose to use pre-prepared breads, cakes, and pies that you just thaw and bake when needed.

Inefficient people can push up costs. Do you know how much work each server is doing, as well as how efficient your kitchen staff are? You cannot afford to keep servers who are not doing their jobs; nor can you afford to keep kitchen staff who can't handle the work. It pays to take the time to hire good staff, and sometimes to pay them a little more.

## LABOUR COSTS

Week of 21 - 27

To date for month of JULY

	Wages	Sales	%	Wages	Sales	%
Kitchen	\$750.00		12	\$2,250.00		14
Dining Room	600.00		10	1,400.00		9
Total	1350.00	6,300.00	22	3,650.00	16,100.00	23

### Monthly

**Food Costs** At least once a month you should analyse your food costs. As part of your analysis make a comparison between your food costs and your labour costs. Check that these costs are what you want them to be, and if you are achieving your overall goals.

A monthly food cost calculation can be used to compare your figures to your past performance, and to the performance of similar restaurants.

The most accurate method of determining your food cost is to count every item in your inventory. Using inventory form sheets can help to simplify the task. You could start by drawing up an inventory book, and making a column listing of each item to be counted. Beside the merchandise column, draw several sets of the following three columns: quantity on hand, unit price, and total cost. Use one set of these three columns per month. The merchandise column remains the same except for adding new items. It is important that the merchandise on the shelves be in the same order as that listed in the inventory book. This makes it easier for the person taking the count as they do not have to search back and forth for the items.

**Note:** You may want to do a daily count of high cost food items such as steaks. Because of the high cost you would not want to lose control of these items. Compare your daily count to the number in your menu breakdown as well.

# INVENTORY CONTROL FORM

	JUNE			JULY			AUGUST		
	Quantity on Hand	Unit Price	Total Cost	Quantity on Hand	Unit Price	Total Cost	Quantity on Hand	Unit Price	Total Cost
MERCHANDISE									
Meat patties	2 kg	\$4.00/kg	\$8.00						
Relish (litre jar)	1 jar	5.40	5.40						
Mustard (litre jar)	2 jars	3.95	7.90						
Onions	3 kg	1.00/kg	3.00						
Tomatoes	2 kg	2.00/kg	4.00						

Once the inventory is counted, your food cost is determined by using a standard formula for calculation.

Month of JUNE

### COST OF SALES FOR FOOD OR BEVERAGE

OPENING INVENTORY		\$ 9,200.00
+ PURCHASES		14,800.00
- CLOSING INVENTORY		11,900.00
= COST OF SALES		12,100.00
$\frac{\text{COST OF SALES}}{\text{SALES}} = \frac{12,100.00}{33,600.00}$	FOOD OR BEVERAGE COST	36%

POSSIBLE REASON FOR HIGH COST \_\_\_\_\_

Above example calculates cost of sales for food only.

**Profit and Loss** This is a good base for determining the success of a restaurant. A profit and loss statement will show your actual income and expenses, and compares them to your projected figures. This is your opportunity each month to take a look at your total business and to investigate if some costs are out of line. Signs of trouble which are ignored could lead your restaurant into financial disaster.

The following income statement is an example of one type used by many restaurants in Canada.



## Yearly

**Profit Plan** Developing a profit plan can help you establish yearly guidelines for your restaurant. Here you will set down the revenue expected from each area of your restaurant and what your projected expenses will be. Compare year-end statements to your profit plan. Prepare a profit plan for the coming year from information based on last year's plan.

### PROJECTED PROFIT PLAN

for the 12 months beginning JANUARY

	MAY	JUNE	JULY	AUGUST
<b>Revenues</b>				
Dining Room		\$35,000	\$40,000	
Lounge		-		
Total		35,000	40,000	
<b>Cost of Sales</b>				
Dining Room		14,700	16,875	
Lounge				
Total		14,700	16,875	
<b>Other Income</b>		-		
<b>GROSS PROFIT</b>		<u>20,300</u>	<u>23,125</u>	
Departmental Expenses				
Payroll		6,300	7,200	
Other		-		
Total		6,300	7,200	
<b>GROSS INCOME</b>		<u>14,000</u>	<u>15,925</u>	
Operating Expenses				
Administrative & General		1,500	1,600	
Advertising & Promotion		400	500	
Heat & Light		650	700	
Repair & Maintenance		200	200	
Total		2,750	3,000	
<b>HOUSE PROFIT</b>		<u>11,250</u>	<u>12,925</u>	
Occupational Expenses				
Taxes & Insurance		1,200	1,200	
Interest		300	300	
Depreciation		960	960	
Total		2,460	2,460	
<b>INCOME BEFORE TAXES</b>		<u>8,790</u>	<u>10,465</u>	

## CONTROLS AS A SYSTEM

Accurate cost and sales records will tell you how profitable your restaurant is, and whether or not you are meeting operating objectives. Controlling the various parts of your restaurant will help you to ensure that those operating objectives are met. Controls make certain you are receiving what you have paid for; that you are getting paid for what you serve; and, that you can protect what you have in the way of food and supplies.

It is essential to control all areas of your restaurant at the same time. Even with full operating controls, a restaurant can lose money if its menu has not been structured and priced just right. Portion control will not be effective if food is being stolen or deliveries are not being checked. Control systems work together. Sometimes the most effective control, and one that is often overlooked, is visual control. Management, without giving the impression they are watching every move of their employees, should make a point of observing the operation of their restaurant to ensure that the rules are obeyed.

The areas of your restaurant which require close control are **purchasing, receiving, storing, issuing, preparation, equipment, dining room administration, and scheduling of employees.**

**Purchasing** How much to buy and when, can be related back to the information you gather in your daily sales report, and in your menu breakdown. This is an important point in control.

Purchasing methods include:

- **Buying to specifications.** You will need a set of specifications governing the types of food you buy, the quality, and the weight you want for all food items. For example, you should know the quality of salmon you want and how your steaks are to be cut. You must also know how much you should be paying for the items you buy.
- **Practicing competitive purchasing.** Constantly check the prices of products you buy with other wholesalers. One wholesaler may be selling a new product you would like to try, or selling your usual brand at a very good price. Do not wait for the sales person to come to you. You may lose out on good bargains.

- Auditing your invoices. By checking all your invoices you will ensure the price you were quoted is the price you were charged. If you order 50 kg of fresh pineapple for \$25, then that should be what you receive and the price you should pay.
- Checking that prices do not increase on pre-costed items. One thing you do not want is to be locked into high prices just because you have that item on your menu. If you have been ordering lamb chops at \$5 per kg and the price goes up a few cents, there is not much cause for concern. However, if the price goes up substantially, you will want to look around for cheaper lamb chops, or take them off your menu. If you continue purchasing at the higher price, your menu prices will be out of line and your food costs will go up.

**Receiving** When the goods you have ordered are delivered to your restaurant they must be checked and stored properly.

- Ensure that all items are checked for quality, quantity, and prices.
- Ensure that you have an accurate set of scales to weigh the items.
- Ensure that you have a competent and honest person to do the checking, if you cannot do it yourself.
- Ensure that perishables are not left out too long before storing.
- Schedule deliveries, if you can, so they come when you are prepared to receive the goods and to check them.

**Storing** Storage safeguards need to be established so that losses are kept to a minimum. Losses come from both the improper storage of foods and from pilferage. The storage area should be well planned according to the needs of your restaurant. It should provide maximum security.

Sufficient place should be allocated for storage, both dry and cold, so that stock can be rotated properly and the items are easy to find. Proper temperature control is required and perishables need to be inspected daily. Practice proper sanitation procedures. Clean storage areas are not only important for health requirements but for safety reasons. Obstacles around the kitchen and on the floor can cause accidents.

Authorized persons should handle the storing. Lock up the store-room and issue the keys only to authorized staff.

Pilferage can come from a variety of sources: deliverymen, employees, customers, and even from unauthorized strangers on the premises. It is a good idea to keep the delivery door locked. Watch not only inventory but equipment.

Pilferage can begin quite innocently among employees. Often in the restaurant industry employees do not look upon food as money. If an employee was working for a jeweler, he or she would not likely take rings home at night. Food is another story. Remove the temptation by locking it up. It is good business to protect your property.

**Issuing** The task of handing out food supplies should be done by the authorized person who maintains control of the stockroom. To make the job of the issuer easier, it may be best to open the stockroom once a day in order to issue food supplies. The kitchen staff should know what they will need for the day, and then receive all their supplies at once. Supplies can be given out in a short time and the area can then be locked. This system can be adapted by operations of all sizes.

**Preparation** Without the proper controls in the kitchen, cooks and chefs will be forced to guess how much to make, and how to make it. If a cook uses a big pot for chili, he or she might make as much as the pot will hold even if sales for chili are not expected to be very high. Too many leftovers cause wastage and push up food costs. Customers do not really like eating warmed up leftovers either.

It is your job to provide the kitchen staff with production guide sheets (daily if necessary). These guides should list what is to be produced each day and the quantities. Guide sheets help the kitchen staff to organize themselves each day. They will know in advance what food to thaw out and what supplies will be needed for cooking. Production is based on your daily sales experiences, seasonal fluctuations, and even the weather.

**a. Standardized recipes** A recipe for every item you produce in your restaurant should be written down and made accessible to the kitchen staff. Every ingredient that goes into the preparation of beef Stroganoff, for example, should be included in the recipe. This means weights and measures of each ingredient, method of preparation, method of cooking, and cooking time. The recipe card ensures your Stroganoff is prepared the same way each time; it ensures quality control. Items such as tomato juice should also have a recipe card. The card

should state that the juice is to be poured into a 150 ml glass, for example.

Standardized recipes are important for new staff. From the information on recipe cards, they will know exactly how to prepare your beef Stroganoff.

**b. Portion control** Because your prices and therefore your food costs are determined according to portions, it is crucial that your staff serve the correct amount to each customer. Specifications for your standardized portions can be provided to all your staff in checklist form or with pictures. Make sure all employees know about the standardized portions, and put your lists and pictures where they can be seen by everyone.

Foods that are purchased already portioned help cut down the risk of serving wrong portions. It may be necessary to use the proper scales, scoops (100 ml) and ladles (250 ml) to get the measurements right. Consistency in the amount you serve to customers is important. A customer who comes in one day and gets a heaping plateful of french fries from a new waiter will likely be very annoyed when he comes in a week later and gets half the amount from an experienced employee. You will risk losing customers.

**c. Convenience foods** The use of convenience foods is a relatively new phenomenon in the restaurant industry. With the soaring cost of labour, restaurateurs are turning to convenience foods to help cut costs. Convenience foods require less preparation time and they speed up service. Buying is simplified because there are fewer ingredients to purchase for pre-prepared dishes. Portion controls are easier. Convenience foods come in a variety of types and qualities. You can choose from frozen, canned, dried, dehydrated, mixed, pre-prepared, pre-portioned, and concentrated foods. The biggest advantage of convenience foods, as opposed to cooking from scratch, is the saving in labour. The making of bread is a good example. A restaurateur who wants to have hot, fresh bread in his or her restaurant can buy the dough, pre-mixed and frozen. The kitchen staff only have to thaw, shape, and put the dough into a pan to bake. There is no mixing and little cleaning. You save on the labour of the cook and the dishwasher.

Convenience foods previously suffered from a bad image. They were labelled greasy and nutritionless. Because these foods have

become so popular, there are now numerous varieties on the market making it possible to buy very good quality. Good quality convenience foods that are properly cooked can be as good as if they were made from scratch. Adding extra spices or some other special ingredients can make these foods very appealing.

**d. Multipurpose foods** Multipurpose foods such as beef, chicken, and turkey help contribute to cost control as well as controlling wastage. From one roast beef, it is possible to offer a roast beef dinner, a hot roast beef sandwich, a cold sandwich, and a beef cold plate. If the entire piece of beef isn't used during a meal period, the remaining piece can be used for a stew. The purpose is to get as much use out of one piece of meat as possible.

**Equipment** The kitchen in today's restaurants should be equipped to fit the needs of today's cooking techniques and methods of food preparation. You do not need to buy the most expensive and elaborate equipment on the market but you should have good quality equipment that will do an efficient job.

The proper equipment can help you increase production and efficiency in your restaurant. A new automatic broiler can save an hour a day. A new automatic slicer can save a few minutes as well as properly controlling the size and thickness of slices. Added up, these savings will increase production significantly.

Once you have invested a lot of money into new equipment, you will want to make sure your employees are using it, and using it correctly. You could be wasting your money if, when you visit the kitchen, you see your cook slicing cold cuts by hand instead of using a new automatic slicer. It is your responsibility to learn what the equipment does and how to get full use of it. The responsibility extends to making sure that your employees are properly trained to operate the equipment. With the consideration of safety, operating the equipment properly is essential. Accidents — burns and cuts — can be quite common in the food preparation area. Employees that take time off work because of on-the-job accidents cost you money.

Equipment also requires care and maintenance. It is not a good idea to wait until your expensive equipment breaks down before calling in someone to repair it. A microwave oven with a broken thermostat can

ruin a lot of food and waste electricity. Refrigerator doors that will not close can encourage spoilage as well as waste electricity. Poorly cleaned equipment will take longer to heat up, produce fire hazards, and even send odours to the dining room of your restaurant.

**Dining room administration** Once the food has reached the dining room you will want to make sure you get paid for what you serve. One method of controlling customer bills is to have all bills pre-numbered, counted, and issued to a cashier or hostess. The hostess then counts and issues bills to each server. The hostess is ultimately responsible, with each server being responsible for his or her own bills. Through dining room controls you will want to eliminate missing bills, items omitted from bills, errors in addition, and walkouts. Walkouts may be difficult to control in some restaurants, but if you have a duplicate bill for each meal at least you can find out what it was for.

**Scheduling employees** Staff should be scheduled in your restaurant based on your sales projections. Too many employees on hand during a slow period is an irretrievable loss. Yet, if there are not enough servers, poor service can result, followed by a loss of sales. Prepare a written employee schedule at least once a week, taking into account your sales, day of the week, season, and if you are having a special promotion.

**Other expenses** Although food and labour are the two major expenses in a restaurant, there are other expenses that need to be watched. These expenses may seem small but they can add up if they are not controlled.

Some of the other expenses to watch are:

- laundry
- paper supplies (towels, napkins, placemats)
- utilities
- china, glassware, and silver replacement
- services (cleaning and equipment maintenance)

## BEVERAGE CONTROL

The beverage operation in a restaurant is kept separate from the food operation for ease of control. Sales and purchases are recorded separately. Control procedures are separate. With the kind of sophisticated machinery available today, a restaurateur can purchase a good cash register which can help with bar controls. Such machines can do a breakdown of the kind of drinks sold, give you a daily sales report, keep track of inventory and add up customers' bills correctly. It depends on what you want and what you can afford.

Beverage costs can be in the 20-25% range or in the 30-35% range depending on what the market in your area will bear. A drink that sells for \$1.50 in Prince Edward Island will probably sell for \$3.50 in Toronto. As with food costs, it is difficult to determine a rule-of-thumb for beverage costs.

Your mark-up and price are determined by your total product:

- market
- concept (atmosphere, decor, food, etc.)

Wine prices are also influenced by market and concept. However, the price of wine is determined on a different basis. Wine sales are considered as extra revenue because the customer who orders wine usually has a meal. The cost of serving that wine is absorbed in the cost of serving the food.

Many restaurants today use the cost-plus method for pricing their wines. For example, you may want to make \$2.00 on each bottle of wine you sell. If you know your customers will pay from \$6 to \$10 for a bottle of wine, you will purchase wines between \$4 and \$8 in order to make your mark-up. Wine served by the glass or by the litre is usually marked up 50% in order to account for loss through shrinkage.

**Control procedures** Observing and being aware of what is happening in your bar operation is one of the best controls you can have. Hire honest people and remove the temptation to take or sample the merchandise. Control measures in a beverage operation are not all 100% effective. However, if you have enough of them you can have control.

A system of control used by many bars begins when the liquor arrives on the premises. As it comes in, each bottle is stamped with your special stamp, entered into a perpetual inventory book, and put away under lock and key. You should keep the only key. The special stamp, called a house stamp, should also be kept under lock and key.

The stock in your bar is controlled by maintaining a par stock, which means having the same number of bottles on your shelves at all times. You may keep a par stock of 30 bottles for example. Some of the bottles may be full, some may be half-full, but your supply is adequate for business that day.

Maintaining a par stock prevents employees from taking bottles. The bartender must account for every bottle. At the end of each day, the bartender makes a requisition for the number of bottles he or she will need to replenish the stock. Before he or she is re-issued the stock, the empties are counted and checked for the stamp. Empties are then destroyed or the house stamp on the bottle is sprayed with paint. The bottles issued are marked in the perpetual book. The liquor in your inventory book must always balance with the liquor on the shelves of your bar. A periodic check is done by you on the par stock at the bar, and on the stamped bottles.

If in the course of checking you discover fewer than 30 bottles you will want to find out where they are. If there are more bottles, find out why. If you find extra bottles and they do not have your stamp, it may be your bartender is selling his own liquor.

Modern cash registers are very useful when used with par stock and stamp controls. The cash register will usually have four breakdowns: liquor, wine, beer, and miscellaneous. Servers can pay the bartender for each drink ordered by a customer or they can be issued tabs to get the drinks. In either case, if the server does not pay, or does not have the right tab, he or she will not be issued a drink. When the drink is run up by the bartender, the tab is placed along with the drink, in front of the customer.

Servers are responsible for all tabs issued to them and must account for each one at the end of the day. Periodic checks should be made to ensure that a tab is in front of every customer. These methods help account for all drinks so that servers cannot pocket the money by not ringing up the bill.

Bar controls are usually followed by several accounting controls. The issues to the bar are broken down, costed, and recorded daily. Purchases are recorded separately as well as in the perpetual book. Transfers of liquor to the kitchen are carefully recorded. At the end of each month an inventory is taken and the beverage cost calculated and compared against the percentage you want to maintain. If your beverage costs are unusually high this will usually be the first indication that something is wrong. Your loss may be caused by the wrong pricing, pilferage, or even overpouring.

The best investigation of possible problems is the one you do yourself. Begin by observing your staff for any wrongdoings and by taking your own inventory if you are not already doing so. A daily inventory may be necessary until you uncover the problem. You may decide to stay after your employees have gone home and check over the bar to see that everything is as it should be.

A well-organized procedure for beverage control can save you time and prevent lost merchandise. Control procedures may be time consuming, but if they are effective you save time from re-checking the merchandise or from monitoring your staff. Merchandise that is lost can rarely be recovered.

**Note:** The figures and percentages that appear throughout the text and that are used in tables are presented only as examples. They do not necessarily constitute an operating guide. Published figures are available on many types of restaurants. Check with your local restaurant association or your accountant.

## CONCLUSION

The rising costs of food and labour, along with competition, make it essential that controls be implemented in order to have a successful restaurant. A restaurateur realistically cannot afford to be without controls.

Effective controls help eliminate operating mistakes. Controls allow you to discover problems at their early stages or before they happen. Controls also provide you with constant information on your restaurant and are an assurance to you that your business is operating according to your plans.

Controls are there to be used. You do not just institute controls and then forget about them. As your restaurant grows, make sure your controls are still adequate. Once you are successful, don't think that you no longer need controls. They are also there to help ensure that you stay successful.

## 4. RESTAURANT ADVERTISING AND PROMOTION

*"It is unrealistic to expect that all your customers will walk into your restaurant by accident. You use advertising and promotion to attract and keep customers." — CASE Counsellor*

INTRODUCTION .....	82
WHY ADVERTISE AND PROMOTE YOUR RESTAURANT? .....	82
KNOWING YOUR CUSTOMERS .....	85
ADVERTISING YOUR RESTAURANT AND BAR .....	86
PROMOTING YOUR RESTAURANT AND BAR .....	92
CONCLUSION .....	101

## **INTRODUCTION**

It is no secret that the success of your restaurant depends upon a well-managed, well-controlled, and efficient operation. However, success also depends upon having customers. In the competitive market of the restaurant industry you must have ways of attracting people to your restaurant and keeping them as customers. Remember, your competition includes not only other restaurants, but also those people who prefer to save money by buying food at the supermarket and eating at home.

Advertising and promotion are the best ways to reach, and to keep, those much sought after customers. A successful advertising and promotion program convinces customers that it is a pleasure to eat at your restaurant and that they can eat good, tasty food at affordable prices. Otherwise, why should they come to your restaurant and not another?

This chapter looks at advertising and promotion for a restaurant, including a bar operation, and gives you hints for your own enterprise.

## **WHY ADVERTISE AND PROMOTE YOUR RESTAURANT?**

It is unrealistic to expect that all your customers will walk into your restaurant by accident. You have to go out and get them, and you have to earn their respect so that they will pay a return visit to your restaurant. Through advertising and promotion you can find your customers and keep them.

Ed and Nancy bought a family-style restaurant, made some improvements in the kitchen and dining area, and opened for business. Right from the beginning, customers were coming in regularly and business appeared to be good.

Yet after a while, both Ed and Nancy were conscious that business did not seem to be as brisk as it was when they first started. Their observation was confirmed by the evidence of their operating controls.

"I think we're in trouble," said Ed. "Not drastic trouble — yet. But the warning signals are there. Our daily sales report and our profit and loss statement both point to a drop in sales."

"That's what I've been saying," replied Nancy. "Our costs are taking a larger and larger percentage of our sales dollars. After I finished doing the payroll last Friday, I figured out that wages were almost up to 31% of sales compared to our regular 27%."

Ed and Nancy had to admit their problem: fewer customers were coming into their restaurant. The drop wasn't large, but it was significant enough to register in their control system. They also knew that if they did not reverse the trend they could eventually face financial difficulties.

"The clientele is still there," said Ed. "In fact, there should be more customers because that new office building just off Main Street is now open."

"Don't forget that in the office building is another restaurant. Plus we've got competition from that new heritage restaurant," interrupted Nancy.

Ed and Nancy decided to assess their competition. They visited both competing restaurants on a number of different occasions and came to some conclusions.

"They're good," said Ed. "But our food is better and I think we have better service. Our prices are about the same, give or take a bit; so that's not the reason for people eating there and not at our place."

"The heritage restaurant is promoting its historic decor and costumed staff. And the restaurant in the new office building is advertising opening specials," added Nancy.

"I guess we've been too busy just running our restaurant. I figured good food, good service, and good controls were enough. Obviously we forgot to include advertising and promotion."

The objective of **advertising** is to tell people that you are in business and to remind them that you are still there. Advertising should convince people to come to your restaurant instead of going to your competitors. It should also create a desire for eating at your restaurant instead of eating at home. Your objective in **promotion** is to make your restaurant the interesting place about which you advertise and to make eating in your restaurant a pleasant dining-out experience.

It is also an important fact that the dollars you spend on advertising and promotion can help you build goodwill for your restaurant which, in turn, increases the overall value of your business.

When you do advertise, you hope for and expect an increased number of customers, but your operation must be strengthened in advance. You will need to feel confident that your kitchen and serving staff, as well as your premises, can handle the increased business. If you are unprepared, not only will you be wasting your money, but the increased activity could put such a strain on your existing operation that you could lose many of the customers you now have.

Your method of advertising and organizing promotions, and the amount of money you spend, will depend upon the type and size of restaurant you own or manage. A truly effective marketing plan uses both advertising and promotion. If your budget permits little or no advertising, a strong emphasis can, instead, be put on sales promotion projects which are less expensive. This does not mean you should forget about advertising completely. Remember, your competition probably will not forget. Planning for continuing growth in your business and in your sales is a healthy sign. When budgets permit, you can look at advertising more seriously. If you wish to expand your business activity, advertising is nearly a must.

The rules of advertising and promotion apply to all types of restaurants from the gourmet and family-style restaurants, to institutional cafeterias. A fast-food kiosk in the middle of a large shopping mall, with many potential customers in the mall, can still benefit from participating in an advertising campaign for the entire mall. Neither is this fast-food outlet exempt from providing good, well-presented food along with a few “daily specials” in order to get as many customers as it can handle. Advertising alone, however, won’t make your business improve. If you aren’t pleasing the customers you now have, how are you going to please additional new customers?

## KNOWING YOUR CUSTOMERS

Before starting to plan an advertising or promotion campaign, you must first study and know who your customers are. The success of your campaign will depend to a large extent on directing your efforts to the customers most likely to patronize your restaurant.

To establish a customer profile there are several points to include:

- the type of people who patronize or who will patronize your restaurant
  - a) their ages
  - b) lifestyles
  - c) income bracket
  - d) occupation
  - e) nationality
- where do your customers live and work?
- how will they get to your restaurant?
- what are their food preferences and where do they eat now?
- do they have a lot of time to eat or are they in a hurry?
- when do they eat in restaurants?
- are the customers likely to come in regularly or are they transients or tourists?

The food you are selling, your location, and your prices have a major effect in determining who your customers are. A gourmet restaurant in a remodeled old home will have a different clientele from a buffet-style restaurant located in a shopping centre. Let us look at what a customer profile may tell you.

If you have been in business for a few years you should know who your customers are. In fact, before you started or bought your restaurant, you probably gathered the same kind of information. It is a good idea to review your customer profile periodically to see if your clientele is still the same. This review is useful both for your advertising and promotion plans and for the kind of food you serve. After such a survey, you might discover that an increasing number of students from a nearby technical college are coming into your family-style restaurant. You might have noticed they were coming in, but your survey shows they are coming in more often, and in increasing numbers. In order to keep this additional business you might want to offer some student specials at student prices.

Most of the information you need to know about your clients can be gathered by observing your customers, by asking your staff, and by asking the customers themselves. Population statistics and information on people eating out are available from governments and local restaurant associations.

## ADVERTISING YOUR RESTAURANT AND BAR

Advertising is any paid communications activity conducted outside your premises in order to bring your restaurant to the attention of prospective customers. Advertising finds customers for you. The types of advertising media you might consider for your restaurant include:

**Newspapers** Daily newspapers are traditionally a popular advertising medium for restaurateurs as they reach a wide and varied audience, and the cost of advertising is fairly inexpensive. People have come to expect newspapers to announce new eating establishments and to advertise various types of restaurants. The weekend entertainment section is especially popular for restaurant advertising. This is when people browse through newspapers looking for new restaurants for their Friday or Saturday night "out-on-the-town". If you think that advertising on the sports page or in the business section is better for your type of restaurant clientele, then you have that option.

Newspapers are flexible. The position of your ad, as well as the copy, can be changed on very short notice. You also have a good chance of getting the size of ad you want. Most daily newspapers have people on staff to help you develop an advertising campaign, to write the copy and to do the layout.

Weekly, community, and ethnic newspapers offer almost the same advertising opportunities as do the larger daily papers. Though circulation is usually smaller, these newspapers reach a more defined audience. Weekly newspapers and community newspapers are often confined to a certain geographical area. Ethnic newspapers are produced for a specific nationality and can have a larger geographical area than a community newspaper.

A medium priced seafood restaurant in a certain community might wish to concentrate its advertising in its community paper. However, that same restaurant might also advertise in the larger daily paper on weekends to attract more people.

**City guide magazines and hotel magazines** Advertising in city guide magazines will help keep your name in front of both the local population and tourists who read the magazine for information about the city. Hotel magazines are usually reserved for registered hotel guests. Restaurant advertising fits in well with the contents of these hotel magazines which are a type of mini city guide. Advertising in city guide magazines can have long-range results for your restaurant. Studies have shown that tourists often recommend restaurants to their friends back home who in turn may be tourists or visitors to your city.

Magazine advertising can be more expensive than newspapers, but costs vary with each publication. With magazines you must send in your ad well ahead of the publication date and last minute changes can be difficult to make.

**Radio** Radio is a significant medium for those advertisers who want to focus on a particular market. If, for example, you have a pizza parlour and your clientele are mainly teenagers you would choose the station whose audience is mainly between 14 and 19 years of age. If you are in a small community with only one station you could then select the times during the day when most teenagers listen to the radio.

An important advantage of radio is that it is a 24-hour medium and you can get your message across several times during day or night. Repetition in radio is important. People usually need to hear the message about your restaurant several times before the name really registers in their minds.

Radio advertising is relatively inexpensive when you consider the numbers of people you can reach. It is also flexible in that you can schedule ads and make changes on short notice.

**Television** Most small business people often forget about television as a possible advertising medium because of the high cost. However, because of the exceptional results which can be obtained from television it should not be overlooked entirely.

If you want to use television, relatively inexpensive ads can be developed by local television stations. There are a number of techniques which stations can use according to the type of ad you want and to your budget.

**Direct Mail** Direct mail advertising is material sent directly to consumers. This can take the form of letters, one-sheet flyers, or pamphlets. Many restaurants mail or deliver advertising in this form to homes in selected geographical areas. Your local Canada Post marketing manager can advise you on conducting direct mail campaigns.

As a restaurateur you can announce specials or just advertise your restaurant through a flyer, a letter addressed to the householder, or a take-out menu in pamphlet form. The most important advantage of direct mail advertising is that you can know exactly who is receiving your advertising. Direct mail can have measurable results when a redeemable coupon for your restaurant is included in the mailing. The cost of direct mail will vary depending on how elaborate you want the mailing to be.

Posters can also be considered by the restaurateur even though they are not sent directly to households. Posters advertising your restaurant can be put up in various buildings and public places in your community.

Direct mail pieces such as posters and take-out menus can also be used inside your restaurant.

**Yellow Pages** The Yellow Pages of the telephone book are a good and inexpensive means of informing the public about your restaurant. Telephone directories often accept not only just a listing of a name, location, and telephone number, but also display advertising. People who use the Yellow Pages usually have made up their minds that they want to find a certain type of restaurant in a certain location.

Start your advertising campaign with an overall plan. A well-thought out plan will help you to determine what you want to attain through advertising and what you should advertise. Ask yourself if you want to stress your convenient location, your special type of food, your unusual decor, or your fast service. A plan will help you determine how much to spend, and help you to keep your advertising costs within your budget. An advertising plan will force you to look ahead; to think in advance about what you want to do for special occasions such as the changing of seasons and public holidays. A plan also helps when you are evaluating the effectiveness of your advertising. It can tell you what you should do the following year.

How much you should spend depends on the size and style of your business. A rule-of-thumb for restaurants is that advertising should be somewhere between two to four percent of sales.

It may seem like quite a gamble to spend money on something about which you aren't sure. But if your advertising is **well-planned and well-conducted**, you should be prepared for increased business. If you do increase your business, you are on the right track. The increase in sales will soon make up for the additional money you are spending. You can try to measure the results of your advertising by counting the meals and drinks you served during a campaign. It is much harder to measure the goodwill you have built up, or to count the number of customers who will return to your restaurant.

To decide what you will advertise and how you will do it may require expert advice. Newspapers, radio, and television companies usually have a staff person to help customers plan an advertising campaign. You can also seek the services of an advertising consultant.

If you absolutely must do it yourself, read up as much as you can about advertising before you attempt to write an ad. You want to spend your advertising money wisely. A good advertisement must be clear and well-written, and have something in it to catch the audience's attention. Your ad is competing with those of all the other restaurants trying to reach the same customers. To write copy that says you have good food and your hours are from 9 a.m. to 9 p.m. is not enough to make people want to eat there. Find something that will make people take notice and, as a result, want to visit your restaurant. You want them to think of you when they get hungry or when they are planning an evening out.

For each advertising medium your copy will be written differently. Know what these differences are and the different types of people you will be reaching with the various media you can use.

Advertising often begins on your own premises with a distinctive sign outside your restaurant. The sign should be visible day and night and should be easy to read. Try to choose a name for your restaurant that is also distinctive and catchy. Mark's Pizza Heaven is better than Mark's Pizza.

An entrepreneur starting a new restaurant or buying an existing one might decide to spend a large amount of money to advertise the opening or change of ownership. The money in this case is usually allocated as part of the start-up costs. If this restaurateur fails to budget and plan for further advertising, many of those customers who first walked in the door may soon forget about the restaurant and business will slacken. The benefit of the initial advertising may be completely lost.

The dollars you have available for advertising will help you decide where you should put the messages about your restaurant. Your budget might restrict you to certain mediums and it is therefore important to make the right choice in order to reach your customers. The mediums you consider should be researched carefully to see if they reach the right people. You might have to use more than one medium in order to get your message to all the people you want.

It is also important to consider whether or not the advertising medium you choose will enhance the image of your restaurant. Distributing take-out menus will not impress potential customers of a gourmet restaurant any more than advertising for a hot dog stand would fit into a slick guide magazine.

Imagine you have a family-style restaurant which specializes in pizza. You think your pizza is the best in town but up to now the pizza has not been selling as well as you would like. You decide to advertise and you have a special two-color flyer designed with a picture of yourself (Margie) along with the headline: "Have you tried Margie's pizza?" In the copy, you also include the necessary information about your restaurant and the quality of your pizza. The flyers are distributed to businesses, apartments, and private homes in the nearby area. To make sure the flyers are really well-distributed, you hire someone to stand near

your restaurant and hand out the flyers to passersby. You also decide you should put an advertisement in the city guide magazine and look into radio advertising.

Another form of advertising which should not be overlooked by restaurateurs is advertising with suppliers. Suppliers of meat, poultry, fish, fruits, and dairy products will often pay part of your advertising costs in order to promote their products. The opportunities for advertising with suppliers are numerous but you must make the enquiries.

Chain and franchise operators do not usually have an opportunity to advertise on their own. They contribute to the advertising of all restaurants in the organization. This type of advertising does not promote one restaurant in particular but all of them, and stresses reputation, service, and quality of food.

Whatever the type of advertising you choose for your restaurant, you will need to make certain your staff are aware of it. Not only should you prepare your restaurant for increased business, but you should also prepare your staff. If you advertise friendly and helpful staff, make sure that they are friendly and helpful. If you advertise something that requires the direct involvement of the staff, make sure that they know all about the campaign and what is expected of them. Customers may ask your staff questions in advance of an upcoming event. Keeping your staff well-informed gives them a sense of involvement in the business and an incentive to live up to the message in your advertising.

If you have a bar it will usually be included in the advertising of your restaurant. (Check provincial regulations regarding advertising for your bar.) Separate ads for your bar are beneficial when you want to promote new drinks, holiday specials, or special events. When you bring in a jazz trio, or any other type of entertainment, it is almost necessary to advertise the bar separately. Entertainment is very expensive and you will need a large number of customers in order to recover your costs. Frequent advertising can help to build up a separate image for your bar.

# PROMOTING YOUR RESTAURANT AND BAR

## i. Your Restaurant

Promotion covers the various activities you undertake inside your premises to complement your advertising effort. Promotion encompasses **menu**, **personnel**, **premises**, and **special publicity**.

**Menu** A menu is your most important selling device. It tells customers what you are serving and at what cost. Not only should the menu be clean and attractive, but it should suit the theme and decor of your restaurant. More importantly, your menu should be truthful, simple, and clearly written so that there is no doubt as to what is available.

A good menu offers customers a fair choice without being too extensive. The choices offered on the menu should be sufficient to encourage people to eat at your restaurant. You may have your specialties as the main part of the menu, but offer other choices for the customers who will want something different.

Producing a menu does not have to be expensive, unless you decide your restaurant needs a high quality menu. Ideally, your menu should be easy and inexpensive to change when you rewrite your menu or adjust prices. Menus come in all forms; even as placemats, chalkboards, or as special effects such as a scroll or newspaper page. Menus may be printed, typewritten, or handwritten. Some small menus are memorized by the server and are presented orally to the customer.

Whatever style of menu you choose, categorize the items so that customers do not need a long time to review what is available. An à-la-carte menu usually categorizes appetizers, entrées, soups, seafoods, steaks, poultry, veal, salads and cold plates, omelettes, cheese, desserts, and beverages. A menu of table d'hôte categorizes each meal and what is offered with each meal.

For each type of menu describe what you are offering so that customers will know exactly what they are getting. A poorly written menu can make customers hesitate. If they are not sure what the price includes, chances are they will take something less expensive. If you offer pepper steak flambé, explain that you are going to serve a 6-ounce steak with a peppery, cream sauce flambé.

If your menu is table d'hôte, describe what the \$10.95 for the pepper steak includes. Does it include bread and butter, juice, vegetables, salad, dessert, and coffee? You might want to mention what is not included. Some menus have these notations on the bottom of each category. Wherever you decide to put these notations, do not hide them. Customers can be upset if they are charged for something they did not know would be added to the bill.

Position is also important on a menu. The top left hand corner is traditionally a good place for listing an item you really want to promote, such as an appetizer which produces a high gross margin. People usually read from left to right, top to bottom. Keep a record of the items you sell and the locations of those items on your menu. If something does not sell well, you could improve sales by moving it to a new location the next time you rewrite your menu.

Find out what customers like on your menu. Study your sales information to find out what your most popular dishes are, and try to build on that popularity by making those dishes a feature on slower days to draw in more business.

The appearance of your menu contributes to its selling power. Photos or line drawings of your meals help to make your menu pleasing to read. You can also set your specialties and features in larger or bolder type. Illustrating your meals, though, can create the risk of disappointed customers should the actual meal not be identical. Therefore, your personnel has to be trained to copy the pictures exactly as they are illustrated.

Variety can give your restaurant the reputation of being an interesting place to eat. Try new things to please your customers. Keep up with the times. Make it your business to know what foods are popular today. Add a health food item or diet specials to your menu. You don't have to change your whole menu to offer specials. An alternative is to attach to the menu a sheet listing the specials.

If you are able to buy a large quantity of strawberries at a very low price, then take advantage of the promotion possibilities. You could offer several types of special desserts as well as special drinks with strawberries added. When you can obtain such a bargain you should be flexible enough to offer the specials at a slightly lower price. Display your strawberry desserts in the dining room. Put a small eye-catching tent

card on each table to announce your specials and their prices. Not only are you offering your customers a change but you are giving them better value from time to time.

In addition to the menu, there are other ways to draw attention to the foods you serve in your restaurant. Some of the popular methods used today are dessert carts, salad bars, fish tanks if you serve seafood, beef roasting on an open spit, an oven where you bake fresh bread, large soup tureens, and ornate coffee machines if you want to promote coffee. If your food looks good when it is being served, other customers will take notice and will want to order the same thing.

**Personnel** A competent and polite serving staff can help you promote your restaurant as much as your planned promotional activities. In fact, your promotion and advertising efforts are wasted if your staff is not motivated, not working to their capacity, and if they treat customers poorly. Your staff are your sales people. By suggesting certain foods to customers they can help you use up extra food or help you increase sales on a special promotion.

Servers and the chef can cooperate to ensure that nothing is left over in the kitchen; that all food is sold the same day it is prepared. If one day the chef prepares more halibut than chicken, or if there is more halibut left over than chicken, then it follows that the halibut should be pushed. It could also be that your profit margin is higher on the fish than on the chicken.

After a server greets a customer he or she could begin by saying that the chef's recommendation of the day is fresh grilled halibut with almonds. Have servers promote your bar. A customer might like an aperitif before dinner or a glass of white wine with the grilled halibut. Encourage your staff to suggest side orders. If a customer orders veal cutlets, the server might ask: "How about a baked potato with sour cream and chives and an order of our delicious sauteed mushrooms along with that?" Or: "Will you have cheese or ice-cream with your apple pie?"

It doesn't take long for servers to ask customers if they would like something else. This will help your sales. You could have your staff make specific recommendations to customers on those items you make and serve well. Your customers will more than likely be pleased at this special attention especially if the food is good.

Strive for a friendly staff who show concern for the customer. Encourage servers to take time to ask a customer if his or her soup was hot enough. Do not wait for the customer to ask to have it warmed up; he or she might not come back again.

At times when your chef is not too busy he or she could show up in the dining room in a clean white uniform and ask customers at two or three tables if they were satisfied with the food. The chef can be quite casual and chat with the customers, make a few jokes and then go back to the kitchen.

The hostess or maître d' in your restaurant plays an important part in making your customers feel welcome. A friendly hostess or maître d' should greet guests at the door, help them get seated, and thank them for coming. He or she could also be assigned the task of familiarizing customers with your restaurant especially if you have a special way of serving.

Motivating your staff takes continual encouragement and training. Regular meetings to discuss the business in general, customer complaints, and compliments are a good way to keep everyone informed. At the same time remind your staff about providing good service and keeping good manners. Tell them which meals and specials you would like them to promote. Learn what the complaints of your staff are and ask for suggestions; some may be quite valid.

**Premises** Both the exterior and the interior of your restaurant can tell people a lot about your business. A good identification sign and a clean, well-decorated exterior is your first drawing card. If customers do not like the look of your restaurant from the outside it is not likely they will go inside. Once customers are inside they must feel welcome and comfortable in order to sit down and enjoy a meal.

People are drawn to good-looking and clean places. However, they also discriminate on the basis of price and on what sort of meal they want. Because first impressions are important, you want to make sure that the message you are giving customers is the right one.

If you have a homey, comfortable restaurant which serves home-style cooking in a medium price range, then your decor should indicate this. Theme and atmosphere will sell your restaurant as well as the food you serve. Your competition might be serving the same food, but be-

cause the decor and atmosphere in your restaurant is so homey and inviting, you may be getting the majority of customers.

Your decor, the food you serve, the way you have the food served, and the way your staff is dressed all contribute to the atmosphere and theme of your restaurant. Your decoration ideas can come from a professional food service designer or even from a friend with good taste. A promotion-minded restaurateur maintains the standard of the restaurant so that the theme is not lost.

Maintenance and cleanliness are vital. Every restaurateur should be aware of local health rules and regulations, and follow them. You are, after all, dealing with food that people will eat. If any part of your restaurant is dirty — the floors, the cutlery, tables, or restrooms — you run the risk of turning people away from your restaurant. Lack of cleanliness may also make them wonder what your kitchen must be like!

Customers also notice the small things about your restaurant such as: whether or not the salt and pepper shakers are filled and clean; if the sugar holder is filled; and, what the condition is of the bottles of condiments. Are there enough napkins? They will notice the way the table is set. If there are wine glasses on the table, it is an indication they can get wine at your restaurant. Customers also notice if your name is on napkins, ashtrays, matches, postcards, or even on glasses. These small promotional items can help keep the name of your restaurant in circulation.

Colour is an important factor in making your restaurant inviting. Colours that suit daytime restaurants are not usually the same for restaurants that serve evening meals. Many restaurateurs today use a white tablecloth over the table with coloured placemats on top. The colour of the placemats is varied according to the hour of the day. Red is usually suitable for daylight hours while brown and other dark colours are used in the evenings.

Air conditioning can take away odours from the kitchen and the smell of food at the next table. It can also help clear the air of cigarette smoke.

Listen to what your customers are saying. Are they saying the premises are too big, that the next table is too close, that the restaurant

is too noisy? Listen to the complaints and try to correct them. Customer comment cards can also help you gather such information.

**Special Publicity** Special promotion activities include food and beverages offered at lower prices, special menus, food and beverage displays, coffee and dessert flambé demonstrations, placemats, posters, give-aways, and souvenirs. It includes write-ups about your restaurant in the dining-out column of your local newspaper.

Promotions can even be as elaborate as the staging of events inside your restaurant. These events should be capitalized upon by describing them in your advertising. Customers might enjoy a classical music trio during Sunday brunch, a fashion show, an art showing, talking to Santa at Christmas time, or shaking hands with a well-known local personality or international superstar. If you bring in an out-of-town celebrity, or if your chef invents a new dish to commemorate Canada's 125th birthday, write and send an accurate press release to your local newspaper and your local radio and television stations. You cannot go wrong by maintaining a good relationship with the press. They can give you a lot of free publicity.

Do not forget that word-of-mouth publicity is one of the best ways of publicizing your restaurant. It isn't through advertising that people discover where their friends like to dine or where celebrities like to relax. Word-of-mouth publicity is not only free publicity, but it is publicity that will spread very quickly if your restaurant is a good place in which to eat.

When planning promotions keep in mind what the competition is doing. If another steak house is offering specials or has set up an elaborate salad bar, counteract with a new idea for serving steak and salad. When the competition does something that works, study their idea and try to adapt it to your restaurant. Do not copy and do not be afraid to be different. You should be the pacesetter, not your competition.

Promotions should be appealing to you as a restaurateur as well as to your customers. Strive to promote those items on your menu that produce the best dollar profit. It is up to you to use every opportunity you can to promote your restaurant.

## ii. Your Bar

**Beverage List** The beverage list for your bar, like your restaurant menu, should be easy to understand, clearly written, and inexpensive to change when prices increase or when you want to add or to delete certain brands. It should not be a major expense to have your beverage list reprinted. The way you design your beverage list will depend upon your decor and style of business; it can be similar to or even complement your restaurant menu.

Whatever design you choose, there are various provincial regulations of which you must be aware. Several provinces require that the prices on your beverage list include the amount of liquor on which your prices are based. If your prices are based on 1 oz. or 1 1/2 oz., you must say so. Some regulations also require that the ingredients in cocktails be listed. For a Hot Rum, you would have to include your 1 oz. of rum, lemon, honey, and cinnamon. This is helpful for customers who like to know what is in their drinks. In most provinces it is necessary to post a list of your beverages and the prices at the bar, in view of all customers.

For the sake of easy reading, your beverages should be divided into groups such as regular highballs, cocktails, beers, wines, cognacs, brandies, and liqueurs. Categorize your ryes, scotches, gins, rums, and wines together and state whether they are imported or domestic.

The choices on your beverage list will be dictated by the type of bar and restaurant you operate. If you own a gourmet restaurant then your bar will likely follow the same theme. Your choice of drinks will be varied with a good selection of the more expensive domestic and imported brands. A family-style restaurant with a small bar may have fewer choices and with brands of the less expensive variety. In any case, customers will want a fair choice just as they do in a restaurant menu.

Promoting your beverage operation can be done gracefully without tempting customers into excessive drinking. To encourage customers to come between four and six p.m., you might offer a small tray of hors-d'oeuvres, peanuts, or pretzels. As the customer sits down, your server should politely ask if he or she would like a drink to accompany the appetizers. But remember, the idea is to serve only a few appetizers,

not to provide a help-yourself service so that customers can eat their dinner at your expense. A little bit of food softens the effect of the alcohol.

Tent cards are a good way to promote items from your bar. You could be advertising the cocktail of the month, a Grey Cup special, a Mother's Day special, or whatever kind of drink you want. You could put the same tent card on the tables in your restaurant. In some cases, you might want to offer the drinks for a small reduction. Maybe you are overstocked with a certain imported beer, and you decide you want to reduce your stock. Make up a tent card to promote the beer. (In some provinces where prices of alcoholic beverages are regulated, reductions may not be allowed. It is advisable to familiarize yourself with your provincial liquor laws.)

Wine can also be a profitable part of the operation of your bar. Merchandise it in such a way that it is attractive to customers. A wine and cheese display at the door begins to promote your wine even before the customers sit down. A tent card on the tables could tell customers about the joy of drinking wine with good food. It could explain that your wines are offered by the bottle and for a complete selection of wines to please consult the wine list. Your tent card could also explain that you offer wine by the carafe and by the glass for certain prices.

In your bar you are not only selling beverages but your service, atmosphere, and prices. Bars with a reputation for watering down drinks might find this bad practice very costly to them. Be honest in your promotions.

**Bar Personnel** Loyal and competent staff can promote your bar as much as a good promotion campaign. Experienced bar personnel are well aware that customers are not only looking for a nice cold drink but also for a way to relax in a sociable atmosphere. Personnel who successfully meet these needs for the customers are rewarded with good tips. Tips are usually important to these staff and this is their incentive to perform well.

To keep this ideal attitude among your bar personnel takes your cooperation. Staff must be encouraged to keep selling, to be polite and, most of all, to feel that they are contributing to the success of your bar. Regular staff meetings are useful to discuss problems and to discuss cus-

tomers compliments and complaints. Keep your staff informed of any special promotions you may be planning. They can help you sell your specials by suggesting them to customers.

For example, during a promotion of strawberry daiquiris, you might have your bartender put on a show as he mixes each drink. An enthusiastic bartender might do this for all drinks. This is good entertainment for the customers as well as good promotion for the bar.

**Premises** People seem to like to be where the action is — where other people are. If you can create such an atmosphere in your bar you could be assured of a full house most of the time. Customers like a place where the action is but one without a rowdy atmosphere; one where people like to be seen and to enjoy a drink and maybe to have dinner afterwards. A successful bar operation can benefit your restaurant.

According to your decor, your bar can be in an area away from your dining room or beside your dining room where the patrons of each area can see or hear each other. For many restaurants a bar is also a holding area for customers waiting to be seated in the restaurant. Sending a customer into the bar before being seated in the restaurant can be a good way to sell drinks. It is important, though, to have an organized system to take people in and out of the bar so they are not forgotten.

Untidy premises, spotted glasses, and uncomfortable or torn chairs will not help you attain success in your bar operation. A place that is well-maintained can give customers the feeling that your bar is well-managed and under good control.

The extras you offer your customers depend upon your style of business, whether you have an expensive operation or one that is fairly inexpensive. The extras include the quality of your glasses, the quality of your furniture, type of bar display, type of music you play, and how your staff is dressed.

Small promotional items can fit into your decor. You might have your name on coasters, swizzle sticks, ashtrays, and matches. These items remind customers where they are and where they have been. Tempt customers to come back again and again.

## CONCLUSION

There are so many similar kinds of restaurants today that you will need something to distinguish your restaurant from all the others. Advertising and promotion can help you set your restaurant apart from your competitors. Advertising helps you find your customers. Good advertisements placed in the best media for your restaurant will reach the people you are looking for and tempt them to come and try your restaurant. Through promotion inside your restaurant you create a theme for your restaurant; you give it an atmosphere that will make it different from others. Promotion gives your customers variety, sometimes a bargain, and a reason to return.

Once you begin successfully advertising and promoting your restaurant do not forget about these activities or you may lose those customers whom you have worked so hard to get. Be advertising and promotion-minded at all times. Regularly look at your bar and restaurant and ask yourself why customers should come to your place and not your competitors'. Your answer will be carried to the public by your advertising and supported by your promotion.



## 5. BUYING OR STARTING A MOTEL/INN

*"Thought and hard work — while not a guarantee to success — are generally vital to it." — CASE Counsellor*

INTRODUCTION .....	104
ACCOMMODATION DEFINED .....	104
BUYING OR STARTING —	
ADVANTAGES AND DISADVANTAGES .....	107
WHAT TO EXAMINE WHEN BUYING OR STARTING .....	108
ASSESSING THE PROFITABILITY .....	114
i ASSESSING THE ESTABLISHED MOTEL/INN .....	115
ii ASSESSING THE NEW MOTEL/INN .....	117
FORECASTING THE PROFITABILITY .....	119
CHECKLIST .....	126
CONCLUSION .....	131

# INTRODUCTION

A motel/inn might seem like an easy business. During the tourist season, when motels and inns are fully booked, it appears that operators just stand behind the counter and take in money. But what about the off season when the tourists have all gone home? What do motel/inn operators do then?

Off season, when business seems to stand still, is a major hurdle in the accommodation industry. Good planning before buying or starting a motel/inn is essential to help you be prepared for slack periods and for other difficulties which will likely arise. A basic business knowledge will help you keep your business on the right track all year.

Planning your motel/inn means establishing business objectives. It means thinking about the type of accommodation business you want and how you wish to develop it. It also means thinking about future expansions and extra services.

But first, start with the idea that you will have to spend a lot of thought and hard work on making your motel a business contender; a business that makes money. Thought and hard work do not guarantee success, but they are generally vital to it.

The purpose of this chapter is to outline some of the major areas to which thought and work should be devoted if you are considering starting or buying your own motel/inn.

## ACCOMMODATION DEFINED

There are several types of accommodation. Below is a general description of these types of accommodation with an emphasis on location, clientele, and price.

**Motels** This is the most basic kind of accommodation, offering usually only a room to sleep in for the night. There is generally no size limit for the basic motel but it can be as small as four to six rooms. Low prices are the attraction of basic motels. Such accommodation usually has a simple interior and exterior decoration. Parking facilities are always

provided, usually outside the private entrances to each motel unit. Eating establishments and gas stations are located nearby, often within walking distance of the motel.

These motels cater mainly to tourists and business travellers who have not made any plans to stay at a particular place the night they are travelling through a town or a city. Locations on highways or in motel strips at the entrance to cities and towns are ideal for attracting this type of clientele. The first motel in the line-up on the highway or in a motel strip has the advantage of filling up first. Drivers coming in to search for a place to stay often stop and try the first one. Many motels fill up with an overflow of clientele from larger motor hotels and hotels during the tourist season and during conventions.

Motels are also located near tourist attractions such as lake resorts, ski resorts, and hunting lodges. Motels near campgrounds can keep a good occupancy rate through the overflow from the campground or on wet and cold nights when campers prefer to sleep indoors. Some tourist attractions can provide clients in both summer and winter if facilities are available for year round activities.

**Motels with a restaurant** Though motels that provide eating facilities are usually larger than a basic motel, both kinds of motels have similar locations and types of clientele. The larger motels are often two-stories and may include other facilities such as swimming pools or miniature golf courses or shuffleboards. The exterior of the building in this type of motel is often more elaborate and the interior is better furnished than the basic motel. For the sake of convenience, many families prefer a motel with eating facilities even though prices are in the medium range. Some of the larger motels also provide kitchenettes and adjoining rooms, another drawing card for families.

Because eating facilities are attached to the motel, these establishments are sometimes located closer to the centre of a town or city. If located near a main highway in an industrial area, for example, the workers from the nearby businesses can help support the restaurant and the traffic from the highway will support the motel.

Depending on the style of the motel, there may be an inside access from the reception area to some of the rooms. Otherwise, most of the rooms are entered by a private entrance from the motel's parking lot.

**Inns** When we think of an inn, the picture of a quaint building in a country setting often comes to mind. Many inns are located in secluded picturesque places, possibly by a lake or in the mountains. Inns can also be found in summer/winter resort areas and tourist towns. The building itself may be an historic structure that is a tourist attraction in its own right.

The scenic surroundings of an inn may be the major attraction for those people wanting to get away for a quiet and relaxing weekend. Many popular inns have reputable dining facilities in which case clients come to enjoy both the food and the setting.

There is contact between guests staying at an inn. This is encouraged by providing a main lounging area with plenty of comfortable chairs and, in many cases, a fireplace. The rooms are comfortably furnished and have an inside access from the reception area. Some inns also have separate motel units with private outside entrances. Inns are small to medium sized and are in the medium price range. Parking is plentiful.

**Guesthouses** Guesthouses provide another form of accommodation for tourists and travellers looking for an inexpensive and informal place to sleep for a night. Guesthouses are usually run from large old family homes which have been slightly remodelled to accommodate paying guests. In many cases, the owner or the owners of the home live in one part of the house and run the guesthouse in another part. Because this kind of operation is small, the service is personalized and the owners can clean and maintain the home themselves. This type of accommodation tends to be less expensive because it is less private and bathroom facilities are shared by the guests.

Guesthouses can be and are located anywhere in a city or town, not necessarily near a motel strip. They are also found beside country roads and sometimes beside highways. Meals are rarely provided but restaurant facilities are often nearby.

**Motel Chains** When deciding to buy or start a motel you also have the option of joining a motel chain. This type of operation is usually franchised.

The franchise fee varies according to the type of franchise you buy. When buying a franchise, the franchisor usually specifies size of

rooms, layout and decor, type and quality of furniture, type and quality of building, and prices. It is advisable to carefully study all aspects of buying a franchise.

## **BUYING OR STARTING — ADVANTAGES AND DISADVANTAGES**

Both buying and starting a motel/inn require preparation and planning beforehand. It isn't as simple as buying or building a motel/inn, walking in the door and opening up for business. Research and planning before you make a large financial commitment will pay off handsomely when you have all the customers you will need, and when they come back again.

There are advantages and disadvantages both to starting a motel/inn from scratch and to buying an existing operation. Starting a new motel/inn takes a lot of research to determine whether or not your venture will be profitable and to lessen the uncertainty. Among other things you will need to conduct a thorough study of your market and location. You will have to calculate the number of rooms you should have for the occupancy rate you can expect. With an existing business, however, the planning has been done for you, you just have to make sure the data are still valid. By studying financial statements and by asking clients and suppliers you can put together a fairly accurate picture of the business's profitability.

The size, layout, and decor of the rooms may not be to your liking in a business you are considering purchasing. Renovations may solve the problem but then renovations are usually expensive. With a new business, you can design and plan the building and its rooms to your preferences. You can choose your own style of furniture, the size of the rooms and whether or not you will have extra recreational facilities now or in the future. The existing business might not have made provisions for a swimming pool in the initial planning and now it is too late; there is not enough room on the property.

A motel that was built a few years ago might now be rundown and require a lot of repairs. The equipment and fixtures may need replacing before you take over, and this will usually involve a lot of ex-

pense. When starting a motel/inn from scratch, you have the advantage of new fixtures and new equipment. Maintenance costs will be low for the first few years.

One of the biggest advantages of buying an existing business is that you are in business right away. You can expect money to come in almost immediately. Your clientele is established. You will likely have experienced staff who are familiar with the business whereas in a new operation you must hire and train the staff yourself.

Before you begin the process of building, you have to acquire suitable property, take care of building permits as well as check for sewage, water, and other utilities. If you are building you could be faced with a late start-up and other construction delays. This can lead to a bad start if you have a loan payment due in July but will not have any money coming in until the business is open in September. A new motel/inn may have to pay cash for supplies until it can establish a credit rating. As for financing, you might find it difficult to obtain money when starting a new business because there are no former business records. Financing for an existing business may be easier, and at a better rate, than for those starting a new operation.

Buying a motel/inn with a poor reputation requires some caution. Lending institutions may not look favorably upon the purchase of such a business. It may take you a while to establish a new reputation for the business and to bring back customers. Starting a motel/inn from scratch requires more work but the advantage is that you can develop it into the kind of business you want.

## WHAT TO EXAMINE WHEN BUYING OR STARTING A MOTEL/INN

There are many aspects to examine before you buy or start a motel/inn. You will want to know exactly what you are committing yourself to. Some of the elements to look at are potential **market** and **competition**, **location**, **building**, **regulations**, **insurance** and **legal**, **employees**, and **financing**.

**Market and competition** Before you go ahead and start a new motel/inn, you must be certain that the area you have chosen really needs more accommodation. If you are buying an existing business, find out why the owner is selling. Maybe the owner is selling because there are too many rooms available and business is starting to slacken. By studying the occupancy rate, your customers, and the competition, you can determine whether or not there is a reason to go ahead and buy or start your motel/inn.

To calculate the occupancy rate, begin by finding out the total number of rooms available in the area you want to serve. Include all hotels, motor hotels, other motels, and inns in that area. The occupancy rate is the percentage of rooms rented per month or per year. This information can often be easily obtained from your local Chamber of Commerce, Hotel and Motel Association, and from other hotels and motels. You can also phone your competition about 6 p.m. every night for two weeks and ask if they are booked. If they are not full, ask how many rooms have not been rented and do some calculations on your own.

If you discover that of all the existing rooms only 70% are rented, then there is probably little need for new accommodation in your area. If buying an existing motel/inn in this area, you would therefore only expect a similar 70% occupancy rate for your business. On the other hand, if the occupancy rate in your area is very high, over 90%, then you could probably expect the same rate. A high occupancy rate can also be a good indicator that a new business would have a good chance in that market.

For more information to help you determine your market, look for data on population growth, business growth, and for any resort and highway development in the surrounding area. If the town in or near where you will be located is thriving, this should be a good indication that it will continue to do so in the future. Local real estate agents can also give you information on land prices and trends, activity in residential and other development areas, and a great deal of information on the local economy. Do not forget about other businesses in the area along with your own observations.

A thorough study of your market includes knowing who your customers are or will be, where they will come from and at what time of

year. If buying an existing business, ask the owner if a record has been kept of where previous customers came from, and if they were tourists or business people.

You will want to obtain traffic counts on a monthly basis for several years for the number of cars entering your town or city, and the number of tourists visiting your area. Look for the number of conventions per year and try to determine whether or not you can expect to receive customers when the larger hotels and motor hotels are fully booked. Maybe you could count on conventioners to book your rooms when the tourist season ends. To help you determine where out-of-town customers are coming from, study your competitors' customers by looking at the licence plates. Business travellers are another important source of clientele. Ask various companies such as suppliers and manufacturers as well as governments where their employees stay while on business. Try to include your business on their list of places to stay.

Do not overlook the local population as potential clientele. You can probably count on some people coming in for weekends, especially if you have a restaurant and lounge and recreation facilities.

Know your competition well. What types of accommodation and facilities do they have? What are their prices? Do one or two have a higher occupancy rate than the others nearby? Find out why. It could be that these operations are well run and provide excellent service. Strong competition means you must be as good or better in order to get a fair share of the market.

**Location** Several factors can affect whether or not you choose a certain location for your motel/inn. It is not a good idea to choose a place just because it is scenic. You have to make sure it is a place where customers will want to stop. A scenic location is, in fact, important for inns and some motels with restaurants. However, if customers find it difficult to find your place or if it is difficult to get off the highway at the place of your business, then it can do you more harm than good. Your business should be easy to get to from airports, bus terminals, and train stations as well as from the main highways through your town or city. Your business should be easily visible from a distance and identifiable with a readable and clean sign. Good access also means good availability of nearby restaurants, gas stations, recreation facilities, beauty salons, barber shops, etc. Yet at the same time, be alert for noisy locations

caused by being too close to the highway, nearby truck stops, or power plants.

When searching for a location find out if there are any plans to relocate a main highway. Such a relocation can have a major effect on a location dependent on road traffic. Know where your competitors are. Several motels together are usually beneficial to each other in a motel strip. If there are no other competitors around, there may be cause for concern. It could be there is not enough business in that location to support another, or even one, motel.

Whether buying or starting a motel/inn, your business should fit into the area you have chosen. The area should give your type of motel/inn the proper atmosphere and setting.

When searching for property to begin a new motel/inn, check prices and the dimensions of the property. If the land will require a lot of expense to prepare it for building, such as clearing and landfill, then you may wish to reconsider. Look into the cost of bringing in services such as water, sewage, electricity, and telephone if they are not already available.

The size of the property you decide upon should be sufficient for the size of building you want. The size of the property should also take into account the need for a parking lot, recreation facilities if you plan to have them now or in the future, and the future expansion of your building. Imagine where the building would look best on the property and check that it is far enough back from a main source of traffic so that noise is not a problem.

**The Building** If buying an existing business or if buying a building for remodelling, one of the first steps is to have the building evaluated. Next, have its physical condition determined and have an estimate made for renovations.

On the other hand, starting a new business entails the much more complicated procedure of building preparation. You can hire an architect to draw up your plans or you can try to do it yourself. Unless you are an experienced builder you will probably have to consult an architect. An architect will ensure that your building is sound as well as knowing the various building codes and building regulations that you must meet.

Before drawing up your plan, visit several motels or inns to get an idea of how the building is laid out and how the furniture is usually arranged. Envisage your building as you would like it and draw a floor plan. Show the location of rental units, office space and reception area, and other facilities such as a restaurant, lounge, swimming pool, stairways, supply areas, entrances and exits, and parking area. Prepare a floor plan for each type of accommodation you will be offering, be it singles, doubles, or housekeeping units with kitchenettes. Show the furniture arrangement. Outline construction type and finish for walls (interior and exterior), roof, floors, windows, and doors. Find out what plumbing facilities will be needed, what kind of heating system you want and whether or not you want air conditioning.

For the furniture, make a list of the items you will need for all units. If you are not sure about what is available, consult a supplier who will usually give you all the help you need.

Once you have done the planning, preliminary bids from contractors will give you an idea of the costs involved.

**Regulations** Each city and town has its own regulations and by-laws. It is up to you to know the ones that will affect you and your motel/inn. Before buying property for a new building, enquire if the area is zoned for commercial purposes and if you can build a motel/inn and restaurant and lounge on that spot. Once you have clearance to go ahead and build, check for building permits, city water and sewer regulations. There might also be certain construction regulations requiring that your building be a certain distance from the highway. Some communities have restrictions on height of buildings, trees, and shrubs. There may be restrictions on the type of access roads you can have as well as restrictions on the size and level of swimming pools and other recreation areas. Fire regulations must also be met. If you plan a restaurant and lounge, there are numerous building regulations and operating standards that you must meet. Even if you are leasing the restaurant in your motel/inn you should be aware what these regulations and standards are, and that they are being met.

**Insurance and Legal** Taking precautions before something unpleasant happens to you is good business sense. Before buying land, have your lawyers check that it has a clear title. Before buying both the building and the land, have the lawyer check that the land has clear

title and that there are no liens against the building or claims against the existing business. A lawyer can also draw up a legal bill of sale.

Your insurance requirements will depend upon you and the type and size of business you have. You should consider fire insurance, liability insurance, and possibly business interruption insurance which, in the case of a fire or similar destruction, would cover your loss of income while you are rebuilding.

**Employees** If you plan on hiring employees for your motel/inn, you must first be aware of your obligations as an employer. There are provincial and federal labour laws regarding minimum wages, hours of work, and holidays. Information on payroll and deductions, etc., are available from Revenue Canada. Laws regarding uniforms require that if you ask your employees to wear uniforms, you must supply them.

A good employer is also aware of good employee relations. The more you discuss what you expect of your employees and what they expect of you, the fewer problems will occur through misunderstandings. Meetings to discuss business operations need not be formal but can just be a casual talk over a cup of coffee.

Many motels provide their housekeeping staff with a training manual. These manuals discuss how employees should look—uniformed, neat, and clean—how to clean each room and in what order different parts of the rooms are washed and dusted. These instructions are given to ensure that every part of the room is cleaned and that the towels, for example, are not forgotten.

The number of people you will need depends, of course, on the size of your business. In a basic motel which is often operated and maintained by a husband and wife team, employees are not usually needed. Larger motels and inns, excluding the restaurant and lounge staff, may have the owners looking after the reception desk while two or three employees do the cleaning. As motels get larger, more housekeeping staff are required and, in some cases, special staff will be needed to do the laundry.

A rule of thumb many motels use is a maximum of 15 rooms per each housekeeping employee. Full-time staff can be hired to clean the rooms, or depending upon your existing staff and on your budget, you may consider part-time help.

**Financing** Once you have completed your plan for a new motel/inn or decided to buy an existing business, you will soon be looking for financing to pay for your project. Unless you have a background in banking it would be helpful for you to study the types of loans available and the different types of lending institutions. You should be aware of the various ways you can finance your project as well as the amount of capital you can be expected to contribute. Not only will this speed up your financing, but it will assist you in getting the right kind of loan. You will want to understand the payment and interest requirements so that you may budget for them properly. Many lending institutions encourage demand loans, which means the interest rate floats and is adjusted every month. The business that has not planned for the increased payment might not survive long if it is barely meeting payments at the lower interest rate. A term loan if obtainable, where interest rates are fixed for a specified period of time, is easier to budget.

Whether buying or starting a motel/inn, ensure that you will have adequate financing before you start in order to avoid future financial problems. Costs could become higher than expected. You could have your building three-quarters finished and run out of money or your completion date could be extended by three months. With your loan payment due the first month and your business behind by three months, you could be in trouble before you start.

When approaching a financial institution for a loan, you will be required to demonstrate to the lender that your operation is feasible and that it will be profitable.

## **ASSESSING THE PROFITABILITY**

Before you go out and buy a motel/inn or try to obtain the money to start a new one, you should know whether or not your operation can be a success. It is a good idea to get all your costs and an operating forecast down on paper to prove to yourself that the business you are considering will be worthwhile. If your study shows that you can be successful, your assessment will then be your initial operating guide.

There are many particulars that will affect your assessment. The size and type of motel/inn you want will have considerable bearing on your financial picture both as to commitment and to possible return on

investment. Your return on investment will be weighed with the time and energy you will be putting into the business as well as with your personal commitments. Even the factor of starting from scratch compared to buying an existing business will make a difference. In starting your own motel/inn, you may be able to develop at a slower pace more in keeping with your finances. On the other hand, while buying an existing motel/inn will mean immediate sales, you may be making a larger financial commitment as well as paying for goodwill, which may or may not exist.

An important factor that will affect your assessment includes the possible need for renovation or remodelling. Remodelling an outdated motel or converting an old house into an inn can often be quite expensive.

## **i. Assessing the established motel/inn**

Evaluating a business you want to buy can be fairly easy because of the company's existing business records. You do not have to guess what costs will be nor try to project sales.

Before analyzing the financial records, you might want to check with local real estate agents on the price levels of recent motel/inn transactions in your area. This information can help you evaluate the asking price of the business. Find out what the owner originally paid for the business and compare it to the asking price. If the difference is quite high then a goodwill charge has been added. You must determine whether or not you can recover this goodwill charge if you resell the business or if, in fact, the goodwill is justified. When calculating your return on investment, use the total asking price — including the goodwill — not just the assets. A general rule for arriving at a purchase price is from three to five times the gross room revenue, depending upon the age of the buildings, furniture, location, room rates, etc.

Part of your evaluation of a business is to ask about the owner's reputation as a business person and if the motel/inn has a good reputation in the community. Check with suppliers, credit reporting agencies, and other people — such as employees — connected with the business for information on credit dealings and a history of the business.

One of the most important tools you will use to help you evaluate the business is its financial statements. Ask for financial statements for

the last three years, or longer if possible, and preferably audited. If the statements are not up-to-date, ask the owner to prepare a statement for at least the current year. If the business lacks financial records, then you should have second thoughts about buying the business.

In the financial records, look for sales trends. Examine whether they are increasing or decreasing, and compare expenses from year to year. One of the key expenses to look for is the amount that the owner has spent on maintenance in the past three years. This will tell you, whether or not any money has been put back into the business. The higher the amount spent on maintenance the better for you, otherwise you will have to budget for possible large expenditures to improve the building's condition. Renovations can be a time factor that delays full business operations.

In your assessment of the building and the property, take a good look at it yourself or, if you prefer, hire an evaluator. Check the wiring, plumbing, and heating. See that the bathrooms in each unit are in good repair, that the televisions work, and that the linens are in good condition. If the motel does not have a restaurant, inquire if the area is zoned for a restaurant and a restaurant with a liquor licence. In a year or so you might want to expand in that direction and you will need to consider the expansion in your evaluation. If there is a restaurant, is it doing well? Do the restaurant and motel complement each other or would you have to spend a lot of money to renovate the restaurant as well? If you are contemplating a motel with facilities such as a restaurant and lounge, then the associated costs and revenues should also be subject to a detailed analysis.

It is important to stress, at this stage, that you obtain the services of a professional accountant to help you analyze the financial situation of the motel/inn. Your accountant should prepare, with your assistance, a forecast for the first year you would own the motel/inn. To give you an indication of the longer term, it is advisable that your forecast be prepared not only for the first year, but also for the following two, three or five years. Your financial analysis should include a cash flow statement. A cash flow will show you, on a month-to-month basis, what you can estimate to receive, what cash you will have to pay out and where you may have cash surpluses or shortages. Because slack periods do occur in the motel/inn business you must know when they will occur in order to plan your business properly.

It must be stressed that a professionally prepared forecast is a must. The amount of a loan needed to purchase a motel/inn along with the interest payments will probably be substantial, unless you can put in a considerable amount of your own money towards the purchase price. Even so, you will want to ensure that your investment is a safe one. A forecast will show you if the profit you can expect will cover business requirements as well as your personal commitments such as a family, home mortgage, and other consumer debts. In other words, a forecast will tell you whether or not you can afford your proposed venture into the motel/inn business.

Before examining a typical profit and loss forecast for a motel/inn, let us look at some aspects of assessing a motel/inn that you are starting from scratch.

## **ii. Assessing a new motel/inn**

Assessing the start-up of a motel/inn is unlike the assessment of an established operation. There are no past records on which to base your analysis. It is, therefore, important that your estimates of sales, expenses, and profits be as realistic as possible. When starting a motel/inn from scratch you will be making many purchases as compared to the one purchase you make when buying an existing business. It is important that you determine exactly what your requirements will be and what the costs will be.

**Your starting costs will usually consist of the following items:**

### **Capital expenditures**

- land
- building
- furniture for rooms, reception area
- uniforms, linens, supplies
- recreation facilities (pool, shuffleboard, etc.)
- access road
- parking lot

### **Opening costs**

- signs
- licences
- start-up, electricity, telephone, gas and water
- insurance
- bookkeeping system
- accounting and legal fees
- architect's fees
- printing expenses for stationery
- advertising and publicity
- taxes
- membership in local hotel/motel association and, if applicable, restaurant association

### **Contingencies**

- unplanned expenses always arise. Allow 10% to 20% of planned expenses

### **Reserve fund**

- two to three months minimum of overhead costs and salaries to cover the possible lack of cash flow during initial period

If you are considering a restaurant and lounge to go with your operation, this will involve listing the start-up costs in the same manner as for the motel/inn. (Many motel owners lease the restaurant and lounge to an outside operator.) If you are trying to limit the size of your loan, you could delay the construction of recreation facilities such as a swimming pool. Another point to consider is that initially, until you have proven yourself, your suppliers may insist that all inventory purchases be on a C.O.D. or deposit basis.

Also be aware that you should not commit yourself to construction of the motel/inn until you have consulted a professional accountant to assess the profitability of your venture, and until you know you have the money available to pay for it. After the assessment by your accountant, you can begin by taking out an option on the property you want. This will ensure that a sudden sale of the land does not put your plans into jeopardy.

Your accountant should prepare a forecast (along with a cash flow statement) for the first proposed year of operation. To assess the longer term, it is again advisable to prepare your forecast not only for the first year but also for the following two or three years. This is required in determining your financial needs, especially in the calculation of operating expenses and a reserve fund. A realistic assessment of sales, expenses, and profit will allow you to determine if the venture is financially feasible for you.

## **FORECASTING THE PROFITABILITY**

The following typical profit and loss forecast (as far as it is possible) is shown for both the start-up of a motel/inn and the purchase of an existing one. The period covered is for the first three months. Ideally, such a forecast is done monthly or, on a quarterly basis within a 12-month period. Some of the expenses shown will be the same each month, some will rise and fall seasonally and some will occur in only a few months of the year. Preparing such a forecast regularly can be advantageous in seeing where low periods or off-season times occur in the accommodation industry.

**Forecast  
Profit and Loss  
For the 3-month period beginning May 1st**

	\$	%
Room Sales	37,094	100
Estimated Expenses:		
Wages and Benefits	10,386	28
Maintenance and Repairs	185	.5
Laundry	370	1
Telephone	742	2
Utilities	1,484	4
Insurance	742	2
Taxes	1,113	3
Advertising	370	1
Loan Interest	927	2.5
Television Expenses	189	.5
Office Expenses	200	.5
Sign Rental	195	.5
Depreciation	556	1.5
General	180	—
Total Operating Expenses	<u>17,639</u>	<u>47</u>
Profit before taxes	<u><u>19,455</u></u>	<u><u>53</u></u>

**Note:** The previous figures and percentages for the forecast are presented only as an example. They do not constitute an operating guide. Published figures are available on many types of motels and inns. Check with your local association or your accountant.

Sales in the forecast are based on an estimated annual occupancy rate of 60% for a motel with 24 units at an average cost of \$28 per night. (Sales = occupancy rate x number of rooms x room rate x number of rental days.) There is no cost of sales as you are selling a service. The total sales, based on realistic projections, show there is sufficient volume to cover operation expenses and to provide a profit. If a 60% occupancy rate (as shown) will not give you sufficient revenue to

cover your commitments, then you should probably reconsider the venture. On the other hand, you could decide the business has potential, but realize that to proceed you will have to make some adjustments. To increase your operating income, you can either increase your sales volume or, through careful analysis, reduce expenses or improve your gross margin if the market permits. Any increase in sales must be realistically attainable and any cutback in expenses must not affect your ability to operate and generate sales.

If you have a restaurant and lounge, your forecast will have to be adjusted to show this part of your operation.

Let us look briefly at the major items considered in our forecast.

- **Labour** Even though you may plan to do most or some of the work yourself, there will still be peak-season needs when you will require extra help. How long will it take to service one unit? How many units will need to be serviced? How many hours of outside labour must be hired? What are the going rates of pay for this type of labour in the area? Consider other costs such as unemployment insurance, sickness, vacations, etc.
- **Supplies** What are the costs of soap, matches, towels and linens, glasses, stationery, and cleaning supplies? Whether an individual item is to be considered a supply item depends upon the likelihood of its being used up in one year. You should, as a part of the cost of getting the motel/inn established, list the type and number of supply items you will need and calculate the investment in opening inventory which you will need.
- **Laundry** Laundry can be done by yourself or contracted out to a laundry firm. Rates should be checked and compared to the cost of setting up your own laundry department.
- **Heating** Electricity and water — estimates can be obtained from the local office of each service.
- **Property taxes** Estimates of taxes can usually be obtained from local taxing authorities. (Do not forget that you may have to pay a business tax in addition to a realty tax.)
- **Maintenance** If your motel/inn is new you may not need to spend much money in the first year or two on maintenance.

- **Sign rental** Signs are usually rented and maintained by a sign company.
- **Ground costs** Includes grass cutting, flower bed preparation, fertilizing, snow removal, etc. — local gardeners can help you with estimates.
- **Professional fees** Professional fees are frequently paid once a year but ask if there are to be variations.
- **Insurance** Get quotes from local agents.
- **Interest on debt** How much money do you need to borrow? At what rates of interest? When will the interest have to be paid? (Usually monthly.)
- **Advertising** Check into the types of advertising best suited for your motel/inn. This includes where you would advertise, the frequency, and the costs of the various media.
- **Depreciation** Although this does not involve an outlay of cash, depreciation should be calculated as the business will have to generate the funds needed to replace assets as they wear out and get used up. In other words, before you can determine if a business is to be profitable you should find out if enough revenues can be obtained to spread the cost of assets (other than land) over their expected useful life. Your accountant can give you up-to-date information on the rates applicable to various types of assets.

It is important to work out your forecast in percentages as we have done. There are many published statistics and national averages, which will allow you to compare your operation to the norm. For example, you might discover that your labour costs are way over forecast or that maintenance costs are out of line. Your forecast then becomes a measuring stick. Comparing your actuals to your forecast by percentages will also be a ready indicator of your performance and will highlight any trouble spots in your operation.

In conjunction with the illustrated forecast, a cash flow statement should be prepared for the same period of time. The purpose of the cash flow statement is to show you, on a month-to-month basis, what cash you estimate to receive, what cash you will have to pay out, and where you may have cash surpluses or shortages.

Assessing the profitability of your venture is a requirement not only for yourself, but also for a lender. For, if your venture proves viable and you need term financing, a lender will want to see your assessment.

**The following table briefly outlines the pros and cons of starting a motel/inn or buying an existing one.**

### **Starting a Motel/Inn**

- must do a lot of research before starting — determine whether or not you can be successful — have to calculate number of rooms needed
- no past business record — may be more difficult to finance because of the unknowns
- can design and plan it the way you like:
  - quality and style of furniture
  - kinds of rooms — single, double, adjoining
  - size of rooms
  - extras — facilities such as swimming pool
  - allow for future expansion in plan
- have a new building with new equipment and new fixtures
- start-up costs higher — landscaping, parking lot and signs are expensive

### **Buying a Motel/Inn**

- by studying financial statements, occupancy rates, clients, suppliers, customers, and expenses, you can find out if business is profitable — may have to pay goodwill if you want a good business
- can borrow money more easily and at a better rate — financial background for the business
- may not like the size and decor of the rooms — rooms may not be laid out properly — may not be any adjoining rooms, nor kitchenettes — would have to examine possibility and costs of remodelling
- building and equipment might be in rundown condition; have to start replacing right away
- parking lot, landscaping, signs, all completed

### **Starting a Motel/Inn**

- no staff — must hire and train them
- have to acquire suitable property and take care of building permits — checking for sewage, water, utilities, etc., can sometimes be a problem — lots of red tape — must know all the regulations for building in your area
- could be delays in construction resulting in a late start-up — if loan payment due in July, start-up not until September, in trouble right away
- takes time to build up a clientele to make your name known — have to get established
- might have to pay cash for supplies, etc. — credit difficult to obtain

### **Buying a Motel/Inn**

- existing staff
- property acquired, building is finished
- no delay in start-up
- business is established — can be disadvantage if the business has a bad name — have to overcome bad reputation
- after your credit rating checked, can get credit more easily for supplies

Part of your feasibility study in building or remodelling a motel/inn, is knowing the total expected costs. You may wish to use this form as a guide.

## BREAKDOWN OF LAND AND BUILDING COSTS

### GENERAL

1 Permits, plans, surveys	\$
2 Supervision fees	\$

### LAND

3 Land purchase price	\$
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### SITE WORK

4 Clearing	\$
5 Services: Sewage	\$
Water	
6 Excavation	\$
7 Fill	\$
8 Paving: gravel	\$
9 Landscaping	\$
10 Fencing	\$
11 Labour	\$

### CONCRETE

12 Footings	\$
13 Foundations	\$
14 Reinforcing	\$
15 Floors	\$
16 Labour	\$

### STEEL

17 Joists	\$
18 Columns	\$
19 Labour	\$

### WALLS

20 Concrete blocks	\$
21 Masonry	\$
22 Woodwork	\$
23 Partitions	\$
24 Drywall	\$
25 Sheeting	\$
26 Insulation	\$
27 Labour	\$

### OPENINGS

28 Doors	\$
29 Overhead Doors	\$
30 Windows	\$
31 Ventilation	\$
32 Labour	\$

### ROOF

33 Roofing	\$
34 Labour	\$

Carried forward \$

### BROUGHT FORWARD

\$	
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### FINISHES

35 Millwork	\$
36 Floors	\$
37 Acoustical Ceiling	
38 Paintings	\$
39 Labour	\$

### ELECTRICAL

40 Wiring	\$
41 Outlets	\$
42 Service	\$
43 Labour	\$

### PLUMBING

44 Materials	\$
45 Labour	\$

### HEATING

46 Materials	\$
47 Labour	\$

### PAINTING

48 Materials	\$
49 Labour	\$

### HARDWARE

50 Materials	\$
51 Labour	\$

### SPECIALTIES

52 Air-conditioning	\$
53 Elevators	\$
54 Sprinkler	\$
55 Sign	\$

### OTHER ITEMS

56	\$
57	\$

TOTAL COST \$

Note: 1 Note with \* where firm price has been obtained  
not an estimate

# CHECKLIST

This section consists of a checklist for you to complete. Some of the questions have been examined in the chapter, while other questions are there as an inducement to enquire further into the aspects of buying or starting a motel/inn. You may also wish to use this checklist as a guide when contemplating the ownership of a motel/inn.

## QUESTIONS

	YES	NO
<b>ACCOMMODATION DEFINED:</b>		
Can you list the different types of motels?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what is involved in running a restaurant and lounge with your motel?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the difference between an inn and a guesthouse?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what is involved in buying a franchise?	<input type="checkbox"/>	<input type="checkbox"/>
<b>BUYING OR STARTING — ADVANTAGES AND DISADVANTAGES:</b>		
Can you list the advantages and disadvantages of buying a motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Can you list the advantages and disadvantages of starting a new motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
As the owner of a motel/inn, are you willing to work long hours and to work hard?	<input type="checkbox"/>	<input type="checkbox"/>
Are you prepared to go into the business without a guarantee of success?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have experience working in the accommodation industry?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have savings and a good credit rating?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have the support of your family?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
<b>WHAT TO LOOK FOR WHEN BUYING OR STARTING A MOTEL/INN:</b>		
<b>Market and competition:</b>		
Are you confident that more accommodation is needed in the area where you want to own a motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what the occupancy rate is? Do you know how to calculate the occupancy rate?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where to find information about the motel/inn industry?	<input type="checkbox"/>	<input type="checkbox"/>
Have you researched your market thoroughly?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know who your customers will be and where they will come from?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the price ranges of various motels?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where to look for more customers?	<input type="checkbox"/>	<input type="checkbox"/>
Have you studied your competition?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what types of businesses they have and how well they are doing?	<input type="checkbox"/>	<input type="checkbox"/>
Do you think that the operation you are considering could be a strong competitor?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Location:</b>		
Is your location appealing and convenient to customers?	<input type="checkbox"/>	<input type="checkbox"/>
Is it easy to get to from highways, airports, and from the centre of your town or city?	<input type="checkbox"/>	<input type="checkbox"/>
Are facilities such as restaurants, gas stations, recreation outlets, and beauty salons located nearby?	<input type="checkbox"/>	<input type="checkbox"/>
Is your location quiet?	<input type="checkbox"/>	<input type="checkbox"/>
Is your business compatible with the surrounding area?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you like the location?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of any plans for development or redevelopment in the area?	<input type="checkbox"/>	<input type="checkbox"/>
If starting a motel/inn, is the property you have chosen large enough for the size of building and recreation facilities you want?	<input type="checkbox"/>	<input type="checkbox"/>
Will it be easy to bring in services such as water, sewage, electricity, and telephone?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where your competitors are located?	<input type="checkbox"/>	<input type="checkbox"/>
<b>The building:</b>		
If buying an existing motel/inn, have you had the building evaluated? Will renovations be required?	<input type="checkbox"/>	<input type="checkbox"/>
If starting a new motel/inn do you know the procedure for preparing to build?	<input type="checkbox"/>	<input type="checkbox"/>
Have you visited other motels/inns to get an idea of how they are planned?	<input type="checkbox"/>	<input type="checkbox"/>
Have you consulted an architect to verify your plans?	<input type="checkbox"/>	<input type="checkbox"/>
Have you listed all the furniture you will need?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Regulations:</b>		
If starting a new operation, do you know if the area you have chosen is zoned for a motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Is this area zoned for a restaurant and lounge beside or in your motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what building regulations you must meet?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of what licences and permits you will need?	<input type="checkbox"/>	<input type="checkbox"/>
Are there any regulations covering the height of your building, and surrounding shrubs and trees?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
If planning a restaurant and lounge, do you know about the numerous building regulations and operating standards?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Insurance and legal:</b>		
If buying a motel/inn, has a lawyer helped you with a bill of sale?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked for liens against the property or building of the business you want to buy?	<input type="checkbox"/>	<input type="checkbox"/>
Are there any liens against the property you want to purchase for a new motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Are you aware of the different types of insurance available for a business?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the difference between fire insurance, liability insurance, and business interruption insurance?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Employees:</b>		
Are you familiar with provincial and federal labour laws regarding uniforms, minimum wages, hours of work, and holidays?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how to prepare a payroll and make the proper deductions?	<input type="checkbox"/>	<input type="checkbox"/>
Have you calculated how many employees you will need?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where to find staff?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know why good employee relations are important?	<input type="checkbox"/>	<input type="checkbox"/>
Have you ever seen a training manual for people working in the accommodation industry?	<input type="checkbox"/>	<input type="checkbox"/>
<b>Financing:</b>		
Are you aware of the different types of loans available?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Do you know the various ways to finance your motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the difference between various types of lending institutions?	<input type="checkbox"/>	<input type="checkbox"/>
Have you asked about payment and interest requirements?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked into whether or not there are any government assistance programs for motel development in your province?	<input type="checkbox"/>	<input type="checkbox"/>

### **ASSESSING THE PROFITABILITY:**

Whether buying or starting a motel/inn are you aware of various factors that will affect your assessment?	<input type="checkbox"/>	<input type="checkbox"/>
If buying an established business, have you determined the value of the assets?	<input type="checkbox"/>	<input type="checkbox"/>
Have you compared the market value of the assets to the asking price?	<input type="checkbox"/>	<input type="checkbox"/>
Have you met with the owner's banker and suppliers?	<input type="checkbox"/>	<input type="checkbox"/>
Have you examined the financial statements of the established business?	<input type="checkbox"/>	<input type="checkbox"/>
Are these statements up-to-date, especially the profit and loss statement?	<input type="checkbox"/>	<input type="checkbox"/>
Have you engaged the services of a professional accountant?	<input type="checkbox"/>	<input type="checkbox"/>
Has this accountant prepared a forecast and cash flow for you?	<input type="checkbox"/>	<input type="checkbox"/>
Have you forecasted sales and costs realistically?	<input type="checkbox"/>	<input type="checkbox"/>
Have you allowed for unplanned expenses?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if buying a motel/inn is financially feasible for you?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
If starting a motel/inn from scratch, do you know all your start-up costs?	<input type="checkbox"/>	<input type="checkbox"/>
Have you forecasted sales and costs realistically for your new motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Have you allowed for unplanned expenses for your new motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Have you set aside a reserve fund for your first few months of operation?	<input type="checkbox"/>	<input type="checkbox"/>
Has a professional accountant prepared a forecast and a cash flow statement for your new motel/inn?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know if starting a motel/inn from scratch is financially feasible for you?	<input type="checkbox"/>	<input type="checkbox"/>

## CONCLUSION

Your knowledge of all aspects of running a motel/inn and good management practices will largely determine how your business will function. Planning before you buy or start a motel/inn will make the difference between a place that is filled most of the time and one that stays almost empty.

Your work in planning for the business does not stop when the motel/inn is finished and in operation. As well as keeping a close watch on costs, you should continually re-assess your operation. Develop a method of finding out how clients learned of your motel. Keep a daily record of how many units are rented and how many customers are turned away.

This kind of planning and organization in the beginning will also be important for the day when you will think about expanding. When that day comes, you will be in a position to make an informed forecast on how profitable additional units will be and how many new units should be added.



## 6. BUYING OR STARTING A SERVICE BUSINESS

*"As the owner of a service business, you are the business's most important asset. Not only must you be proficient in what you are selling but be able to manage the business at the same time." — CASE Counsellor*

INTRODUCTION .....	134
TYPES OF SERVICE BUSINESSES .....	134
WHY START A SERVICE BUSINESS .....	135
HOW TO GET STARTED — WHAT SHOULD YOU LOOK FOR? ...	136
PLANNING THE START OF YOUR SERVICE BUSINESS .....	137
ASSESSING THE PROFITABILITY .....	142
i ASSESSING THE START-UP OF A NEW BUSINESS .....	143
ii ASSESSING THE EXISTING BUSINESS .....	145
FORECASTING THE PROFITABILITY .....	147
CHECKLIST .....	150
CONCLUSION .....	154

# INTRODUCTION

Service businesses cover a broad spectrum. They can range from small insurance brokers and hairdressing salons to sellers of computer software. The common denominator to these businesses is that they exist to provide a service. Their chief inventory is the capacity of the people working in the business to render or sell a wanted service rather than a physical product.

A service business is still a business, however, and requires that its owners and managers possess good management skills in order to make the business a success. Planning, thought and hard work are vital to success.

The purpose of this chapter is to examine the major areas you will need to consider before buying or starting a service business. These are the areas you should be thoroughly familiar with and sure of, just as you need to be sure that the service industry is for you.

## TYPES OF SERVICE BUSINESSES

The variety of service businesses is so great that the simplest categorization would be to divide them into business oriented and into consumer oriented services. A business serving other businesses could be consultants — everything from management, engineering, architectural, personnel, and word processing — to sales agencies, audio visual services, and management training services. Consumer oriented services make up the businesses that meet consumer wants. Some of these services are home cleaning, home repairs, entertainment organizers, fashion consulting, day care, and gardening services.

If service businesses can provide an almost endless number of services, they are also flexible in the premises they can choose to operate from. Location will, of course, depend upon local zoning laws and how much walk-in traffic a business will need. A plumbing business could easily be started in a home, as could a nursery school or day care centre. A consultant may start up a business from home or from rented office space. A hairdressing salon might prefer to begin its business in a rented storefront, as might a home cleaning service, or security service.

Flexibility in location can make starting a service business less costly than starting other types of businesses. Service businesses do not usually require a high investment when compared to businesses that must invest in expensive equipment, merchandise, and costly renovations before they can receive their first customers.

Buying a franchise service business can be expensive. Franchises are available in almost every segment of the service industry and the costs vary from franchise to franchise. When buying a franchise, the planning and research are usually done for you. On the other hand, franchises present many restrictions with which you must abide if you wish to keep the franchise. The franchisor will specify style of service, layout and decor of the business, prices, and location as well as some other factors. Before buying or starting a new franchise, it is advisable that you know all about franchises. (See chapter 1)

## **WHY START A SERVICE BUSINESS?**

As we have stated, service businesses meet the wants in our society; the wanted services that make our lives easier. With shorter work weeks, longer paid vacations, early retirements, fast-food outlets, and labour saving devices in the home, our leisure time is increasing. People want to use their leisure hours to enjoy themselves, not to be occupied with completing small chores. These people are prepared to pay for services that will save them time. Tasks we did by ourselves are now given to someone else whom we pay for the service. The business community also looks for ways to save time or for people who have a certain expertise to do jobs that they cannot do or will not do themselves. That someone else could be you who wants to buy or start a service business.

The way you interpret which services are wanted depends upon your skills and your imagination. Some keen observers of the marketplace have successfully created plant sitters, leisure time organizers, telephone answering, and messenger services. If you have expertise in a field, it is possible to think of a way to use that skill in a business of your own. With people looking for more ways to save time, you can also create a need for a service and, with proper management, make it work.

If you have a good idea and you want to make a go of it on your own, there are certain qualities you should possess. A talent that somebody else wants is not enough. You will need the ability to sell your service and to be service oriented yourself; to be willing to help, to listen, and to deal with customers. You will have to like the type of people you will be dealing with. Many service businesses build their reputations on the personality of the owner. If people like you, and you provide a good service, they will keep returning as long as your business exists.

## **HOW TO GET STARTED — WHAT SHOULD YOU LOOK FOR?**

There are several points you should consider before deciding whether to start a new service business or to buy an existing one. There are advantages and disadvantages to both. In some cases you may not have any choice but to start a new business if the kind of service you want to provide does not exist.

One of the most important considerations is money. Starting a new business of your own can cost you less than purchasing an existing one. If short of money, a new business can be developed at your own pace and according to your finances. If able to start from your home, you can keep expenses to a minimum by avoiding a high rent and costly renovations. Purchasing an existing business may cost more because you will have to pay a considerable amount for goodwill. You will need to determine if the price (including the goodwill and not just the assets) is justified.

Even if the business you are considering purchasing is successful, you may not be completely happy with the way it is run. If you want to buy it, you will have to accept the business as it is and make the changes you would like. This may take time and some changes may be costly. You could lose some customers in the process. In an existing business you already have the volume that has to be so carefully built up in a new business. When starting new, you must find your clientele and make them want to return.

Beginning from scratch is hard work, but you have the advantage of creating the type of business you want. You can choose the location, interior decoration and layout, style of service, and type of clientele. It

is difficult to determine the volume you can expect in a new business. Begin by studying similar businesses in the industry or by seeking professional advice so as to arrive at realistic estimates. Try to persuade former contacts and clients to use your new service.

In an existing business, it is easier to determine volume and profitability because you can study the business's previous financial records. With this information you will be able to prepare an accurate business and financial plan.

If you are considering buying a franchise, the groundwork is already done for you. The purchase price of a franchise usually includes a pre-opening program that tells you how to start the business, the costs involved, your market, how to advertise, and so on. Your financial outlay can be substantial for a franchise but you usually have a greater chance of initial success.

## **PLANNING THE START OF YOUR SERVICE BUSINESS**

If there is one device that you, as the owner/manager of a small business, should use to the maximum it would be planning. Planning is especially important when starting a new business to help you find out what you are committing yourself to. Planning continues through to the day you open your business and as long as the business remains open. The person who tries to cope with incidents only as they occur in everyday business sometimes does well, but this is often good luck and not good management. A business plan will give you direction as your business gets underway. A plan will give you something with which to measure the performance of your business once it becomes established and will help you plan for future growth.

Planning requires a lot of hard work to get your business launched. If you are not prepared to do the groundwork, you should question whether or not you could keep the business going. A thorough examination of the factors that might affect your business can save you money and time, and help you to ensure that your business continues to grow and to be profitable. Begin seeking your information from associations, libraries, financial and management advisers, from people al-

ready in the business, people who use similar services, your local Chamber of Commerce, Statistics Canada, suppliers, and distributors. Some of the elements to look at are potential **market** and **competition**, **location**, **regulations/legal/insurance**, **employees**, and **financial planning**.

**Market and competition** When we talk about a market, we refer to the area of a town or city your business will serve. The boundaries are not always definite as you may have clients from adjacent areas. The definition of a market includes who the clients will be, their willingness to use your service, how much they will pay, and where they are in relation to your business. The location and number of competitors will also influence your market.

In your study of the area you want to serve compare the income levels according to what you estimate the cost of your service to be. Try to determine if people would easily find your place of business and how you would reach that possible clientele through advertising.

To determine the potential for your service business, ask people whether or not they would use your service. This could be done by a door-to-door survey, a telephone survey, or by sending a self-addressed and stamped letter. If you want to start a carpet cleaning service, as an example, find out how many homes in the area have carpets and, who cleans them now. Find out if people rent cleaning machines or if they hire someone to clean their carpets. State in your letter that you are thinking of starting a carpet cleaning service. Ask if they would use such a service and how often. If there is already such a business, ask if they think that the service is sufficient. A market study for someone considering a management consulting service would follow the same procedure except that the survey would be directed at businesses in the area.

If there is strong competition, you must be prepared to do a superior job. There is a plus to being located near other service businesses. People like comparative shopping and other similar businesses can help you generate volume. Shopping centres are one example where several types of stores together can help each other. In larger cities you can have as many as four hairdressing salons in one centre.

**Location** Once you have established the need for a specified service you should have a better idea about where to locate.

The location, of course, depends upon the type of service you will have. If you are planning a plumbing repair service or a small insurance business, it is possible to begin from your home if local zoning laws permit. If the day comes when you want to expand, you have the choice of moving into storefront premises. Since a business in a home will not be visible to customers, you must be listed in the local telephone directory. Supplement this with some well-planned advertising and soliciting on your own.

People who would like a business address but do not really need (or cannot afford) an office can buy an identity package. Small consulting or sales companies usually find this option very appealing. The company selling the identity — a service business itself — will sell you an office address and a telephone number in an office complex which you can have printed on business cards and on stationery. The service includes someone to answer your telephone, to handle correspondence and invoicing plus a range of other office services depending upon how much you want to pay and upon your requirements. Savings result because you do not have to rent, or equip, or staff an office of your own. Locating near clientele is not as important in the case of some consulting and sales companies who will be dealing with clients in all parts of a city or town.

For service businesses that require a storefront location — hair-dressing services, handbag and luggage repairs, etc., there is more to consider when searching for the right location. Your first thoughts should be for convenience and choosing a location that is visible to everyone. An easy-to-spot business will attract passersby and will make it easy for clients who are trying to find you.

A convenient location means being accessible to public transportation and being near parking facilities. Distance from customers will be determined by how often they will be using your service. A laundry service will have to be closer to its customers than a rug cleaning or income tax service.

Before you choose a location, try to determine the traffic count. Over a period of four to five days, count the number of people who pass by at various times of the day. From time to time stop people and ask them whether or not they would use your service at that spot. If

people seem willing to answer questions, have a prepared list of additional questions you would like to ask. The questions could range from why people like or don't like the location to how often they use your type of service. Some service businesses are located in shopping centres where it is easy to find the pedestrian count from the mall's management. Whatever the location you finally decide upon, ensure that the type of business you want is suitable to the location and to the surrounding district. Check for future building and relocation plans that could affect the area.

The building itself should meet your needs now and in the future. Consider size and to what extent leasehold improvements will be required. You may need a long-term lease in order to amortize expensive improvements and to make them worthwhile. If you are prepared to negotiate a long-term lease you must be sure that the business will be successful.

Buying a building for your new business is usually not considered advisable, but may be a consideration once your business is well established. Being the owner of a building often means you have two businesses on your mind instead of just one. If your service business fails, you still have a building to support. You could stand to lose more money if it remains empty and you are forced to sell.

**Regulations/insurance/legal** All types of businesses are required to meet some operating regulations and it is your responsibility to know which ones will apply to you. The various levels of government may require that you have certain business permits or licences. Your accountant, lawyer, and other people in the same business can give you guidance.

Even if by law you do not have to be a qualified plumber to open a plumbing business, your customers will certainly feel more confident if you are qualified. There are several ways to display craft certification through the use of business cards, stationery, or a diploma on your office wall.

Adequate insurance can protect you in the event that something serious happens in your business. You cannot really afford to be without some types of insurance. Depending upon the type of business you will have, you should consider fire and theft, business interruption insurance, and service or product liability.

A lawyer can help you understand your lease if you are renting premises and draw up a legal bill of sale if you are buying an existing business. This person can also check over any other legal documents you might have with regard to opening up or starting a new business. If you are considering a partnership, it is essential that you execute a partnership agreement and a buy and sell agreement before you start the business.

**Employees** A small service business may require only part-time clerical help the first few years of operation. You, as owner/ manager, will carry the heaviest workload. Once your business begins to grow and you become busy, it might be a mistake to try to do all the work yourself. It may be more profitable for you to hire a helper to take over some of the work so that you have the necessary time for visiting potential clients and generating more business.

People in small business are often so involved in the work they are doing that they do not have the time to think about the future. You may know there is a large potential for business in the marketplace and an extra employee could help you get it. Employees are expensive, however, and you must be sure you can justify them before you start hiring. If summer is a busy season for you, consider student employment. If you need someone with specific qualifications, look to schools that train people in your type of business. Schools are a good source of potential employees both part-time and full-time.

Being a successful owner/manager requires that you are able to delegate work, authority, and responsibility. Practise good employee relations by understanding the rights of your employees, by being honest and fair, and by making them feel a part of the company. Happy employees feel that they can contribute to the success of the business. Familiarize yourself with labour laws, severance obligations, holidays, vacation time, overtime, wages, etc.

Employees help create the image of your business. Honest and pleasant employees can help you create the image that will attract customers.

**Financial planning** Financing usually presents one of the biggest stumbling blocks for small business. A thorough understanding of how you should apply for a loan, the different types of financing available, sources of financing, and a complete understanding of the various kinds

of loans will help you to obtain the best possible financing. A lack of understanding of interest payment requirements can put your business in jeopardy. During inflationary times, interest payments may be increased over the course of the loan (depending on the type of loan). If your business is barely making the interest payments to begin with, a higher interest payment could put your business in a crisis situation. Check all sources of financing including government grants and subsidies that could apply to your kind of business. Service businesses in particular may have difficulty obtaining sufficient financing as they usually have few assets that can be used as collateral to secure a loan.

The most successful approach when talking to a lender is to be as well prepared as you can. If you have to borrow money you must first prove to yourself that your project can be successful. Otherwise, how can you convince a lender?

The data you gather on market, location, and clientele is a good basis for calculating the amount of financing you will need. Determine how much of your own money you can put into the business and then try to borrow the balance. It is not advisable to go into business on a shoestring. You will need sufficient money to conduct your business, to cover possible short-falls in revenues, and to take advantage of growth potential.

The business plan you finally present to a lender should contain several points. Outline the type of business you want to begin and how you will go about it. Describe yourself, your experience, education, and your ability to manage a business. Show the results of your feasibility study (market, location, clientele). Explain who is involved or is assisting you with the project. Outline how much money you will need, what you plan to do with it, and how you will pay it back. To demonstrate profitability, include financial statements such as a profit and loss forecast and a cash flow.

## **ASSESSING THE PROFITABILITY**

Owning a business is a high risk proposition. Before you invest any money, you should be certain that the business you want has a good chance for success. Otherwise, you will be better off investing your time and money elsewhere. Not many people can afford to lose

their savings through carelessness. A lender will be interested in how profitable you expect the business to be when you are looking for financial support. If your study shows that you can be successful, this assessment will then be your initial operating guide.

The most important factor that will affect your assessment is whether you will be starting a new business or buying an existing one. By starting your own new service business, you could easily limit start-up costs by setting up business at home. As your business grows, you can grow and expand at a time when you will be better able to afford the cost of more elaborate premises. If your kind of business or zoning regulations mean you cannot begin at home, costs can be kept down by renting in a suitable building, at a modest rent, that does not require expensive renovations. With a new business you must be prepared for a slow period as your business builds up. This will initially mean a lower income even though you will still have to cover your costs and personal living expenses. When buying an existing business, you are in business immediately and you can expect a regular income right from the start. The cost of going into an existing business is usually higher than starting from scratch. If the business you are considering is successful and has an established reputation, you can expect that the selling price will be higher. The owners have probably added a goodwill charge that to them is justification for the repeat traffic that might be expected, and for a good reputation for service. Goodwill charges should be carefully evaluated by the purchaser to determine whether or not they are justified.

## **i. Assessing the start-up of a new business**

Assessing the profitability of a new business can be difficult. There are no past business records on which to base your predictions. The expertise comes in assessing as accurately as possible how much volume you will do and what it will cost you to do business for the first year. To help you make the most accurate estimate, look for operating standards for other similar service businesses. Outline what you want to do step by step and determine how much each step will cost you.

**Your start-up costs will usually include the following items:**

**Capital Expenditures**

- office furniture
- leasehold improvements: painting, decorating, electrical, plumbing
- tools or equipment

**Opening Costs**

- leasing a vehicle
- gas
- leasing office equipment
- insurances
- stationery
- professional fees: lawyer, accountant, architect
- rent or lease deposit
- telephone
- utilities, start-ups
- advertising
- travel
- bank charges
- membership in local service-association
- inventory

**Contingencies**

Unplanned expenses always arise. Allow at least 20% of planned expenses.

**Reserve fund**

Three to six months minimum of overhead costs and salaries to cover the possible lack of cash flow during initial period.

If you can begin your business at home, you will not have to pay much for leasehold improvements. Capital expenditures can be limited to a desk and to the tools or equipment needed to do your job. You could also limit costs by leasing a vehicle instead of buying one. If you must hire help right from the beginning, include wages in the start-up costs.

Inventory may be required by certain types of service businesses. A bookkeeping service might sell ledgers, a stenographic service may sell cassettes, and a hairdresser may sell shampoo and other hair aids. Inventory, in these cases, must be included in the start-up costs.

To calculate accurately the total costs, it may be best to use the services of a qualified accountant. An accountant will assist you in preparing a forecast for your business. An operating forecast is one of the most useful tools available to people in business. It will not only show you the cost of doing business but can also point out things about your business that could cause you some difficulty if left unattended. A forecast should be prepared on a quarterly basis for at least the first year you would be in business and preferably for the following two or three years as well. This is required in determining your financial needs, especially in the calculation of operating expenses and a reserve fund. Along with the forecast, you should also have an accountant help you prepare a cash flow statement. A cash flow statement will show you on a month-to-month basis what cash you estimate you will receive, what cash you will have to pay out, and where you may have cash surpluses or shortages. Before we show a typical forecast, let us look at the aspects of buying an existing business.

## **ii. Assessing the existing business**

Assessing the profitability of an existing business is easier than assessing the start-up of a new venture. You have the previous financial records to help you make your evaluation. Before you start examining the books, ask why the owner is selling the business. Is it because this type of service business will be going out of fashion within the next few years? What is the owner going to do after selling the business? Open up a new place in a better location? Find out what other businesses in the immediate area know about the business you are considering buying. Suppliers and customers can also offer helpful information. A meeting with the owner's bank manager may assist you in your assessment.

From the existing financial records, you can study operating costs, the lease, payables, and receivables. Look for discrepancies in costs and try to find out the reasons. Determine whether or not equipment and office machines are obsolete and how much replacement costs would

be. Review the terms of the lease. Look for the amount of money the previous owner has put into the business. The records should also tell you what the sales volume is. If you cannot find out sales volume, or a good estimate of the number of customers, or the state of the receivables, reconsider buying the business. Maybe the owner is hiding something.

Ask for audited financial statements preferably for three years. Never buy a business unless the vendor will provide you with a profit and loss statement no matter how plausible the reasons are for not having one. If the financial statements are old and outdated, ask for current ones. Take some time to study how the business works. Try to spend at least one day on location watching as business is being conducted. Does the business have a good image? Are the premises clean and tidy? Is it the kind of place you would go to yourself?

Ask if the owner will stay around for a few weeks and help you to get to know the business. If the owner agrees, he or she may ask for a nominal salary.

Before you arrive at a price, look the statements over carefully and take them to a qualified accountant to help you understand and evaluate what has been going on in the business. Your accountant should help you prepare a forecast (along with a cash flow statement) for the first year you will own the business. A forecast must also be prepared for the following two or three years. This is necessary to give you an indication of what will happen in the longer term.

A well-prepared forecast is a must. It will tell you what you can expect by buying the business and whether or not you should buy it. You will want to ensure that your investment of time and money will give you the necessary return to meet your personal financial commitments.

## FORECASTING THE PROFITABILITY

The following is a typical profit and loss forecast for one year. It is not illustrative of any particular service industry, but shows how costs would be presented on such a statement. A forecast is prepared ideally on a quarterly or monthly basis for at least one year. Actual operating costs should then be compared on the same basis to the forecast so as to monitor progress. Only if conditions in the market place change substantially would you re-do your forecast. The purpose of comparing actual results to the forecast is to ensure that the necessary steps are taken to achieve what is forecasted. If sales are not forthcoming as estimated, the necessary steps must be taken to correct this or, conversely, costs must be reduced in order to achieve your required profit level.

# FORECAST

## Profit (Loss) Statement

### Period Ended December 31

Sales — Merchandise	\$ 40,000	
Income — Service	<u>75,000</u>	
Total Revenue	115,000	100%
Merchandise cost of sales	<u>20,000</u>	<u>17</u>
	95,000	83%
<b>Expenses:</b>		
Vehicle Rent	3,000	3
Vehicle Operating Cost	3,000	3
Telephone	1,000	1
Fees, Acct./Legal	1,500	1
Insurances	3,000	3
Office Expenses	3,000	3
Depreciation	1,000	1
Interest/Bank Charges	5,000	4
Advertising	10,000	9
Bad Debts	3,000	3
Maintenance	500	-
Office Salaries	11,000	9
Service Salaries	35,000	30
Rent	<u>8,000</u>	<u>7</u>
Operating Expenses	<u>88,000</u>	<u>77%</u>
Operating Income (Loss)	<u><u>7,000</u></u>	<u><u>6%</u></u>

**Note:** The previous figures and percentages for the forecast are presented only as an example. They do not constitute an operating guide. Published figures are available for many types of service industries. Check with your local association or your accountant.

The income from services is money earned by performing the service you decide upon. The sales from merchandise are whatever you want or need to sell in order to complement your service.

For the purposes of this example, we assume you are renting an office and paying all the utilities yourself. Your office expenses include everything from stationery and supplies to printing costs and you have part-time help coming in three times a week. The service salaries are for one employee and for the owner. Gas and travel expenses are your costs for travelling to and from meetings with customers and for doing work on their behalf. Depreciation expenses are for the machinery or equipment you have acquired in order to conduct your business. Although this does not mean an outlay of cash, depreciation should be calculated as the business will have to generate the funds needed to replace assets as they wear out and get used up.

Bank charges involve the cost of borrowed capital and for an extra line of credit. Advertising should not be overlooked. For the first year at least, advertising expenses should be 10% of gross profit. In succeeding years, if the business is prospering, this might be reduced to about 5%. You must tell customers that you are in business. Otherwise, how will they find you? Check into the types of advertising best suited for your business. Bad debts are another factor. Depending upon your type of business, you will have clients who will not pay on time and some who will not pay at all. An allowance must be made for bad debts.

The forecast has been worked out in percentages. There are many published statistics and national averages that will allow you to compare your operation to the norm. Also make comparisons of forecast percentages to your actual business percentages. This is a good indication of performance. If wages or office expenses become very high, then you know this is an area that needs some close examination.

Assessing the profitability is not only for yourself but also for a lender. If you need financing, your lender will want to see your assessment of how profitable the business will be.

# CHECKLIST

This section consists of a checklist for you to complete. Some of the questions have been examined in the chapter, while other questions are there as an inducement to enquire further into the aspects of buying or starting a service business. You may also wish to use this checklist as a guide when contemplating the ownership of a service business.

## QUESTIONS

	YES	NO
<b>TYPES OF SERVICE BUSINESSES:</b>		
Can you define a service business?	<input type="checkbox"/>	<input type="checkbox"/>
Can you name some types of service businesses?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what is involved in buying a service franchise?	<input type="checkbox"/>	<input type="checkbox"/>
<b>WHY START A SERVICE BUSINESS:</b>		
Have you studied different types of service businesses?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know how to sell a service business?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have special skills that others might want?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have a good idea for a service business?	<input type="checkbox"/>	<input type="checkbox"/>
Have you worked in a service business such as the one you want to buy or start?	<input type="checkbox"/>	<input type="checkbox"/>
Do you like dealing with people?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have the support of your family?	<input type="checkbox"/>	<input type="checkbox"/>
Are you willing to work long hours and to work hard in order to make your business successful?	<input type="checkbox"/>	<input type="checkbox"/>
Can you plan the start-up of a business?	<input type="checkbox"/>	<input type="checkbox"/>
<b>BUYING OR STARTING — ADVANTAGES &amp; DISADVANTAGES:</b>		
Can you list the advantages and disadvantages of starting a new service business?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
Can you list the advantages and disadvantages of buying an existing service business?	<input type="checkbox"/>	<input type="checkbox"/>

## PLANNING THE START OF YOUR SERVICE BUSINESS:

### Market and Competition:

Have you done a study of the area you want to serve?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know who your customers will be and where they will come from?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what services they like to use now?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know where to look for more customers?	<input type="checkbox"/>	<input type="checkbox"/>
Have you studied your competition?	<input type="checkbox"/>	<input type="checkbox"/>
Can you keep up with your competition?	<input type="checkbox"/>	<input type="checkbox"/>
Is there a need for your service in the area?	<input type="checkbox"/>	<input type="checkbox"/>

### Location:

Have you thought about the best location for your service business?	<input type="checkbox"/>	<input type="checkbox"/>
Do you like the location? The building?	<input type="checkbox"/>	<input type="checkbox"/>
Can you afford it?	<input type="checkbox"/>	<input type="checkbox"/>
Is it convenient for your customers?	<input type="checkbox"/>	<input type="checkbox"/>

### Regulations/Insurance/Legal:

Have you checked into the permits and licences you will need to get started?	<input type="checkbox"/>	<input type="checkbox"/>
Are there regulations for starting a business in your own home?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the types of insurances you should have for your business?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know what business interruption insurance and service of product liability insurance are?	<input type="checkbox"/>	<input type="checkbox"/>

	YES	NO
If buying an existing service business, has a lawyer helped you with a bill of sale?	<input type="checkbox"/>	<input type="checkbox"/>
Have you checked for liens against the business you want to buy?	<input type="checkbox"/>	<input type="checkbox"/>
If renting a building, has a lawyer helped you understand the lease?	<input type="checkbox"/>	<input type="checkbox"/>

### **Employees:**

Do you know how to go about hiring an employee?	<input type="checkbox"/>	<input type="checkbox"/>
Do you understand provincial and federal labour laws regarding minimum wages, hours of work, and holidays?	<input type="checkbox"/>	<input type="checkbox"/>
Have you ever prepared a payroll and made the proper deductions?	<input type="checkbox"/>	<input type="checkbox"/>
Have you thought about how an employee can help you in your business?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know why good employee relations are important?	<input type="checkbox"/>	<input type="checkbox"/>

### **Financing:**

Are you aware of the different types of loans available?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the various sources of financing?	<input type="checkbox"/>	<input type="checkbox"/>
Do you know the proper way to approach a lender for a loan?	<input type="checkbox"/>	<input type="checkbox"/>
Do you understand payment and interest requirements of the various kinds of loans?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have savings and a good credit rating?	<input type="checkbox"/>	<input type="checkbox"/>

### **FORECASTING THE PROFITABILITY:**

Whether buying or starting a service business, are you aware of the various factors that will affect your assessment?	<input type="checkbox"/>	<input type="checkbox"/>
---	--------------------------	--------------------------

	YES	NO
Have you determined your start-up costs for a new service business?	<input type="checkbox"/>	<input type="checkbox"/>
Have you forecasted costs and sales realistically?	<input type="checkbox"/>	<input type="checkbox"/>
Did you set aside a reserve fund for your first few months of operation?	<input type="checkbox"/>	<input type="checkbox"/>
Have you allowed for unplanned expenses?	<input type="checkbox"/>	<input type="checkbox"/>
Has a professional accountant helped you prepare a forecast and a cash flow statement for a new service business?	<input type="checkbox"/>	<input type="checkbox"/>
Is it financially feasible for you to start your own service business?	<input type="checkbox"/>	<input type="checkbox"/>
Have you studied the business you are considering purchasing?	<input type="checkbox"/>	<input type="checkbox"/>
Do you like what you see?	<input type="checkbox"/>	<input type="checkbox"/>
Would you like to work there?	<input type="checkbox"/>	<input type="checkbox"/>
Have you studied the financial statements of the established business?	<input type="checkbox"/>	<input type="checkbox"/>
Are these statements up-to-date?	<input type="checkbox"/>	<input type="checkbox"/>
Have you visited the owner's banker and suppliers?	<input type="checkbox"/>	<input type="checkbox"/>
Is the owner prepared to stay for a few weeks to help you become familiar with the business?	<input type="checkbox"/>	<input type="checkbox"/>
Has a professional accountant helped you prepare a forecast and a cash flow statement for the existing service business?	<input type="checkbox"/>	<input type="checkbox"/>
Can you afford to buy the service business?	<input type="checkbox"/>	<input type="checkbox"/>

## CONCLUSION

A service business is unique in the beginning. You, the owner, are its number one sales person. When work is slow you have to be prepared to be out soliciting in order to pay the bills.

You must spend time at your craft as well as running your business. You will need to be in control of all functions involved in running and managing a business. Take the time and the effort to do both well. Do not become confused about what business you are in or you might end up promoting the wrong business. A plumber stops being in the repair business when sales of plumbing fixtures take over.

Draw up a business plan, compare your operating results on a monthly basis to your forecast, and look out for changes so you will not be caught off guard.

The Federal Business Development Bank also publishes a free quarterly news bulletin called "Small Business News" to help smaller Canadian firms keep in touch with business developments. This can be obtained by contacting any office of the FBDB or by using the following order form:

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06 ☐ Other \_\_\_\_\_  
(please write in)

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(Please print or type)

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# PLANNING YOUR OWN BUSINESS

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Document  
Publications

Planning in a manufacturing business .....	7
Marketing strategies .....	25
Production guidelines .....	49
Materials management .....	73
Labour utilization and motivation .....	85
Controls for small manufacturers .....	97





**Federal Business  
Development Bank**

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de développement**

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**Volume 4**

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# Manufacturing

## Table of Contents

Foreword .....	page 5
CHAPTER 1 Planning .....	page 7
CHAPTER 2 Marketing .....	page 25
CHAPTER 3 Production .....	page 49
CHAPTER 4 Materials .....	page 73
CHAPTER 5 Labour .....	page 85
CHAPTER 6 Controls .....	page 97



# Foreword

This book has been written as a guide for entrepreneurs who are planning to start a manufacturing business or who are already in business and want to broaden their background knowledge on operating a successful and profitable manufacturing business.

Establishing a manufacturing business requires a detailed and analytical approach. It is not a decision that can be made overnight: all the pertinent details should be carefully researched and planned. A manufacturing business, whether it's a small woodworking shop or a large production line operation, represents a substantial financial and personal investment for the independent owner. Once in business the range of decisions is vast, from acquiring machinery and equipment to marketing the product.

Manufacturers today must be constantly up-to-date on changing technology that may affect their machines, equipment, and production methods. Financial institutions are demanding more information from their clients and potential borrowers. Equipment, raw materials, and supplies are becoming more expensive. Markets are harder to identify and the general business climate is more uncertain. Competition is keen and more substitute products appear in the marketplace every day.

For the potential manufacturer, getting started involves market testing and finding out whether there is a demand for your product. Who will buy it, what price will they pay, and what quantities will you sell? You must look for the proper premises in the right location, search for the best suppliers, locate the proper machinery, estimate your total costs, and draw up a basic business plan to determine if your idea is economically feasible.

Once this preliminary groundwork has been taken care of, you can submit your proposal to your financial backers who will analyze your plans from their financial perspective.

Each chapter in this book outlines the essential components that should be considered, and also provides advice on the priorities and sequence of actions to be taken. While the book provides guidance in the establishment of a new manufacturing facility, it can also be of considerable assistance to the owner/manager of an existing manufacturing

plant who wishes to streamline operations. Organizational shortcomings can be identified and corrected, priorities can be reexamined and plans can be formulated which may lead to a long-term advancement of the company's position.

Basic business principles for manufacturers are discussed in each chapter and are equally applicable to small, medium or large enterprises. In order to illustrate these principles, two examples have been used throughout the text to represent the small custom operation and the larger production concern respectively.

Although no special knowledge or training is necessary, several concepts introduced in the following chapters are based on the assumption that the reader has a fundamental understanding of small business management. In certain sections, the reader will be referred to Volume 1 of the "Minding Your Own Business" series, which covers these general principles in greater detail.

# 1. Planning

The corporate plan .....	page 8
Why plan? .....	page 9
When to plan? .....	page 11
What type of plan? .....	page 11
Long-term .....	page 12
Short-term .....	page 12
Immediate .....	page 13
Developing a plan .....	page 13
Evaluating the plan .....	page 20
Planning tips .....	page 21
Planning assistance .....	page 22
Conclusion .....	page 23

# THE CORPORATE PLAN

An important key to successful management is the implementation of an effective planning and control process. If you have been in business a few years it is likely that you have initiated some kind of planning, whether it has been a formal procedure or not. If you are starting a manufacturing operation then you must develop plans for both the initial start-up and the anticipated growth. The secret to a successful plan is to write it down, monitor its progress, and revise it when circumstances change.

This initial step presents the most difficult and challenging task for you; it requires a clear written statement of the objectives of your company as seen in the light of present economic conditions. The plan sets the pattern for the formation of the business, the tone of the operation and the goals that are to be achieved. If it is properly conceived it should clearly demonstrate the problems and opportunities inherent in your venture. It should also prove to be a positive tool in seeking financing, since it demonstrates to the investor or lender that you are aware of both the potential and the pitfalls of your business.

To be effective, the plan must be dynamic in order to stimulate a prompt reaction to problems. It takes considerable effort to study your operation carefully and to know what is really happening so you can respond with confidence when an internal or external situation threatens the survival of the business.

Your head start comes from being prepared with good plans. It is impossible to set down a plan (whether short or long-term) "carved in stone"; every eventuality cannot be anticipated. A good plan includes alternatives in case internal or external factors force you to change your direction. The alternatives might not be exactly what you had hoped to achieve with the original plan, but at least they should keep you going. Don't let the concept of planning frighten you. Often you already have a plan, even though you haven't formalized it on paper. Planning is a process that should exist in the smallest of businesses. No matter what the size and type of business, there is always room for planning. Once you get started, you'll find it adds an entirely new dimension to the excitement of running your own business.

## WHY PLAN?

Few companies can remain viable without maintaining a growth pattern. Usually a company cannot stand still and continue to be a profitable venture; it must look ahead continually in many areas including the following:

1. New products.
2. Improvements to existing products.
3. Changes in the technological environment and production methodology to improve product reliability, quality and cost.
4. Extensions to marketing plans to encompass new customers and sales territories.
5. Improvements or expansion to buildings and equipment to maintain or expand product capacity with a view to increasing its market share.
6. Advertising and promotional policies.

This is planning. The considerable amount of work entailed in preparing the corporate plan puts you in a frame of mind that encourages you to examine future possibilities. Furthermore, a detailed analysis may demonstrate the degree of risk in the enterprise before any investment decisions are made.

Planning may help overcome some of the more common problems that occur in small manufacturing businesses:

1. Too little start-up capital and insufficient funds for long-term operation.
2. Ignoring or underestimating capital costs and the need for working capital.
3. Failure to foresee built-in product obsolescence.
4. Failure to negotiate favourable terms with suppliers.
5. Lack of self-discipline and weak motivation.
6. Overextension of credit to customers.
7. Poor marketing plans and strategies.

It should be obvious that the planning process cannot be made without help. Explore all sources of pertinent information: Trade Associations, Consumer Affairs organizations, Federal and Provincial Departments, consultants, CASE counsellors, and university or college

business schools. Comprehensive data will be invaluable in supporting your decisions at a minimum cost.

In formulating plans, especially in the start-up phase of a new business, you would be well-advised to seek professional help from your lawyer, accountant, or other advisers. A business that is poorly conceived from the start can't help but run into problems in the future. Your initial investigation should include the following:

1. The design and manufacturing "state of the art."
2. The location and size of your initial market.
3. The current purchase and leasing costs of production equipment.
4. The location of approved suppliers, and delivered costs of raw materials.
5. The cost and availability of competent labour.
6. The regulations (if any) imposed on the design and marketing of your product (i.e., Canadian Standards Association, patents, trademarks, etc.).

Planning can affect all areas of your business:

- It makes predictive control possible. It will make it easier to anticipate what will happen in the critical areas that determine the health and profitability of your operation.
- It allows you to operate and to develop your business in an organized way.
- It helps to get your product out of the plant and into the marketplace in an organized, efficient manner.
- It helps to establish and enforce production standards as well as quality and process controls.
- It encourages you to monitor, measure, and report on the operation of your business.
- It helps establish communication lines within your company, no matter what the size.

## WHEN TO PLAN

As mentioned earlier, planning should be an ongoing process; however, there are certain situations that necessitate a new plan or an alteration to the old one.

Planning should take place before any major decision is made:

- Before you buy new machinery
- Before you hire additional employees
- Before you open up or expand a sales territory
- Before you increase or decrease production
- Before you open up a new shop or expand operations
- Before you launch a new product or service
- Before you change your pricing structure

It should be a continuous and automatic process, since your business is not a static entity but one that is constantly changing and evolving.

## WHAT TYPE OF PLAN?

Generally, corporate plans are composed of two types: short-term and long-term. We have, however, identified a third type of plan which may be less formalized than the others but should still be recognized as an integral part of the planning process: the immediate plan.

The type of plan that you develop is naturally determined by whatever you are planning for. All three types of plans can exist in the overall corporate plan to achieve one major objective.

The immediate plan is action-oriented, including the implementation of tactics to achieve longer-term objectives. The short-term plan generally focuses on strategies and on assessing the impact of certain events. The long-term plan presupposes success in the initial phases and focuses on developments which may be anticipated in the future.

Listed below are the three types of plans and what normally would be included in each for the major aspects of a manufacturing business: production, marketing, and personnel.

## Long-Term Plans

(the “foreseeable” future — two to three years)

- Production:** How will plant facilities be employed over the next three years?  
This includes addition of capacity, manpower, and equipment **if** forecasted demand is maintained. Sales and financial forecasts are included. (The plan states that sales and financial results must be reevaluated before any final decisions are made to increase staff, upgrade equipment, or significantly increase expenses otherwise.)
- Marketing:** What marketing initiatives must be established in order to achieve corporate objectives?  
This includes objectives for volume growth, market share, and pricing to maximize the profit margin. Also new product research and development must be considered.
- Personnel:** What will be the manpower requirements over the long-term and what employee programs will be initiated?  
This includes employee availability, employee training, benefits, and communications programs.

## Short-Term Plans

(strategies and initiatives — one month to one year)

- Production:** A master production schedule covering a certain period of time.  
This includes a control plan to verify all schedules, costs, transportation, and distribution. It should also include an inventory plan to cover the same period reflecting inventory levels in relation to production and sales forecasts, turnover frequency of inventory, and prices.
- Marketing:** The strategies required to attain the marketing objective.  
This includes pricing, sales targets, advertising and promotion campaigns, product development, and distribution strategies.

**Personnel:** Sub-plans to effect changes in manpower requirements, and development of employee programs.  
This includes training programs, safety programs, benefits package, bonus plans, and communication strategies.

## **Immediate Plans**

(tactics — daily plans, weekly schedules)

**Production:** Prepare schedules for the week, assign work orders, and monitor deadlines.  
This includes material needs, inventory levels, equipment maintenance, quality controls, process controls, and delivery of orders.

**Marketing:** Develop and implement tactics of marketing strategy.  
This includes sales campaigns, placement of advertising, monitoring programs.

**Personnel:** Establish and monitor staff requirements for production and implement communication programs.  
This includes hiring personnel, bonus plans, employee newsletters, meetings, and implementing training programs.

There are also corrective plans: a plan to correct a bad decision or to counteract an unexpected attack by the competition. These types of plans require quick decisions and immediate implementation, which are easier in a small manufacturing enterprise because there is usually less internal red tape than in a larger organization.

## **DEVELOPING A PLAN**

The first stage in developing a plan is to determine your objectives. To do this you must analyze your company or your proposal in relation to the immediate business environment, problems, and opportunities. Have you picked a geographical location that will be an asset to running

your business? What are the needs of the marketplace and have you identified all potential customers? Do you have a fair and competitive compensation package that will attract and hold competent employees? Is your business based on a solid financial footing?

Once you have determined where you stand today then you must visualize where you see your business going if it stays on the present course. This is the stage where you must try to be as realistic and impartial as possible. There's no point in misleading yourself. Next, you must determine if where you *appear* to be headed is where you *want* to go.

At this point, a long-range corporate plan can be developed and short-term plans for implementation can be established. Only after this has been done should you consider the finer points of planning the individual tactics such as purchasing supplies, hiring staff, or creating an advertising campaign.

To summarize, there are six basic steps in developing a sound plan for your manufacturing business:

1. Analyze the past and present
2. Predict the future
3. Determine your goals
4. Evaluate your objectives
5. Develop strategies
6. Define tactics

## Investigation

Making a plan requires the detailed investigation of a number of elements, and in order to focus your attention on these elements, you should ask yourself several questions. The answers to these questions will, in general terms, form the basis for your approach in the areas of operating strategies, management organization, marketing and production planning, and management controls.

1. What are the economic and technological characteristics of your industry?
2. What trends are you aware of that suggest future changes in economic and/or technological characteristics?
3. If trends are identified, what is the time frame for their impact?

4. What is the nature of the competition within your industry?
5. What are the requirements for successful competition in this industry?
6. What yardsticks should be applied to
  - (a) The share of the market?
  - (b) The expected rate of return on sales?
  - (c) The expected rate of return on investment?
7. What level of skills do you require of your technical and direct labour personnel, and are these available to you?
8. Are the requisite materials available at competitive prices and in a reasonable time?
9. What are the positive factors in your proposed location with respect to your short-term and long-term market territory?
10. Assuming that indications are positive after detailed research into the foregoing questions, where do you want your company to be in both the short-term and long-term?

## **Back-up Information**

Having completed the corporate plan and having determined that the indications are positive, you must now prepare the detailed back-up information to support it.

### **Financial**

- Prepare an operating budget. This requires an estimate of the gross sales and the cost of sales, as well as a precise analysis of operating overheads, and selling and administrative costs. You must establish competitive prices as well as the necessary production volume and sales to break even. Do not be too optimistic at this stage, especially for a new business, since it is doubtful that you will be able to generate a profit in the short-term. (See chapter 6 for Break-Even Analysis.)
- Prepare complete details supporting capital costs of building and equipment (if you are going to buy) and the time frame from organization to initial production. The time frame is critical since no revenues can be expected before production, testing, and marketing.
- Prepare a Cash Flow Statement. This will provide information on the amount of capital funds required to finance purchases (or leases) of equipment and realty as well as the working capital needed to

purchase inventories, finance start-up costs and cover initial operating expenses. Examine the advantages or disadvantages of leasing (premises, equipment, etc.) vs purchasing assets or building premises, and assess the cash flow and depreciation implications.

- Determine the time frame for the capital requirements of your plan.

### **Marketing**

- Determine your marketing objectives. Do you handle sales directly through dealers, or through distributors? Look carefully at the cost implications.
- Determine your long-term, short-term, and initial market coverage. Examine the cost and revenue implications.

### **Evaluation**

- Establish a method of controlling and monitoring financial and time frame implications in relation to the corporate plan.
- In every sense be conservative in projections of revenues and realistic in costs.

The corporate plan determines the establishment, organization, development, and future targets of your enterprise. It is flexible and should be progressively modified in the light of circumstances that may not have been anticipated initially. Moreover, it should be considered an ongoing statement of your intent and the basic document against which you can monitor and compare your results.

## **Developing a Plan for YOUR Manufacturing Co. Ltd.**

The basic planning steps introduced on page 14 are listed below in point form. Each step is accompanied by an example from a fictitious manufacturing operation that you own.

1. Analyze the present status of your business
  - image and reputation
  - sales
  - competitiveness

- promotion/publicity
- product successes
- staff
- etc.

*Your production has been increasing steadily. Machines and manpower are expected to be near capacity in two years. Your product has a unique advantage over the competition's and has been accepted in the marketplace.*

## 2. Predict the future

- determine what you need and want
- review recent forecasts from external sources
- review previous forecasts (your own and external)
- compare success with previous plans
- seek outside advice (advisory board, market surveys, statistics, manufacturing and trade associations, etc.)

*Because of increased production, you would like to purchase more machinery and to increase manpower accordingly. If expansion is delayed, your machines may break down and require repairs (hindering present production) and the company will have to incur the high cost of overtime wages because you can't subcontract the work. You would like expansion to take place in 2 years. If income and sales remain at present rate of growth, two new machines will be required (for increasing processing of raw materials). Additional manpower (five) will be required for processing and production. Outside economic forecasts predict upswing in industrial sector. Other businesspeople and industrial market surveys confirm this opinion. Previous forecasts from same sources have been accurate for market growth but underestimated inflation rates and cost of capital compared to where economy and sales stand today.*

### 3. Determine goals and prepare plan

- input data accumulated above
- prepare long-term plan
- determine short-term and immediate plans required to achieve long-term goals

*Your long-term plan is established with the objective of increasing production capability to match rising sales. Short-term plan is prepared to determine at what point additional machinery and/or staff will be required. Your immediate plans include finalizing financial arrangements and advising employees.*

### 4. Evaluate the plan and your objectives

- is it realistic?
- were previous forecasts accurate?
- what are the chances of completing it?
- what circumstance could alter it?
- is your plan broken down into long-term, short-term, and immediate plans?
- what will it cost?

*The plan is realistic if you want to be able to handle the increased production properly with no adverse effects. The staff is presently working overtime to meet production deadlines. Your sales forecasts (as of this date) indicate sales and income should increase steadily in order to justify expansion, and previous forecasts were close to what actually happened in the marketplace. Forecasts could change for several reasons, however: economic changes, new and better-priced product introduced by competition, present production efficiency not maintained, or prices on machinery go up too much. If all the variables remain as predicted, you can begin purchasing equipment in 1 1/2 years and commence with training and hiring of new staff. Costs have been calculated and you will circulate them to your key personnel. Also, you will review the project at the next meeting of the planning committee.*

5. Develop strategies and, 6, define tactics

- what do you want to achieve from the plan (be very specific)?
- how will you achieve it?
- who will be involved?
- who will be responsible?
- how will company resources be allocated to reach goals?
- develop support programs
- tell employees about plan
- do you have short-range plans to achieve long-range goals (or plans)?

*Your goal is to increase sales by 20 percent without any major complications or delays. You need the proper machinery for the job, as well as trained personnel. In two years the company should be ready to expand with new equipment; sales and income should justify the increase. You must ensure that as many variables as possible are under control so that your plan can go ahead. Enlist cooperation of all key personnel; they must be aware of the overall plan and should begin to develop their own short-term plans to ensure the company stays in a position to meet its goals. Your marketing and sales staff create plans to keep up sales and to watch competition; purchasing agent is to develop new purchasing plan for increased materials; accounting staff will ensure that costs are under control and that financing is available to purchase new machines and to pay the five new employees. Training program for your new employees gets underway. Shortly before the plan is implemented all employees should be advised and encouraged to cooperate: it requires a total company effort in order to succeed. Managers of each department are responsible for writing sub-plans and establishing tactics for reaching goals. Overall responsibility goes to your plant manager. (Each department assigns areas of responsibility according to the plan).*

If you are building up inventories or purchasing new machinery based on marketing or sales forecasts, make sure that figures aren't overly optimistic. It's easy to increase sales figures by a certain percentage, but if they are only based on guesswork it could get you into a lot of trouble.

# EVALUATING THE PLAN

Once your complete plan has been prepared, you should review it to ensure that it makes sense and to determine whether you have missed something.

By writing out the plan in full, you have defined a course of action for a particular situation. As situations evolve, your plan should indicate what you must do, thus saving time and money. Your subsequent decision should fit into your plan and not hinder your development.

A follow-up evaluation is also required. This can be done daily, weekly, monthly, or semi-annually, depending upon the circumstances. A situation such as increasing production should have a semi-annual evaluation.

Scheduled evaluations have several objectives:

- to decide if plan is on course, and if not, to list what circumstances have changed
- to give you time to discuss changes and to predict what else could happen
- to change support programs and sub-plans

In the example of your hypothetical manufacturing operation, the plans were evaluated at three months and at six months, and everything was considered to be on course.

Let's look further down the road:

*At one year, the economy is showing signs of downturn: sales are going down, workers are not as busy, income is down, and expenses are rising. The forecasts need some revision. Six months later, the plan is no longer on course (this is the point where preparations would have begun for implementing plan to buy new equipment, and hire new staff). The economy is still showing signs of downturn: prices remain high and interest rates are up, making it more expensive to buy equipment and materials. Sales manage to go up a bit but nowhere near the predicted levels.*

*You re-evaluate the plans six months later, during the company's peak season. Now, two years after the plans were established, sales have dropped drastically, and production cutbacks and staff layoffs may be necessary. Your plan must be revised and adjusted to fit the new situation. Your goal now is to keep production level as steady as possible. Each departmental sub-plan must also be revised. Evaluations will be done at 3-month intervals to determine company's position in the changed economy. Expansion is now out of the question but it should be reviewed if the economic situation takes a turn for the better.*

Considering the plans that you had for this manufacturing operation this wasn't the happiest of endings. But imagine where you would be if you hadn't prepared at all — you would probably be wondering how you could possibly make so many poor decisions in such a short period of time.

## PLANNING TIPS

**Plan for just about anything.** You want to try to schedule your time, and to plan your week in order to finish the activities that will affect the performance of your company.

**It is never too late.** Take time to look at the problems you are experiencing and develop a plan to solve them before the consequences are serious. Planning should become a routine procedure in managing your business.

**Get it on paper.** Once a plan is on paper it may not appear in the same perspective as when it was in your thoughts. Writing forces you to look more closely at your ideas. Later, when evaluating your progress, you can see precisely what your plan was and how far you have progressed in achieving the objectives. Putting your plan on paper gives you a point at which to start the next plan.

Planning also makes you more aware of new circumstances or changing economic conditions. Without a plan you may not realize how profoundly these changes are affecting your business.

For example, let's assume that a few years ago you planned to build a new and larger building at a certain price and mortgage rate. Today, in a review of the economic situation and your company's finances, you find that you now cannot afford it. Your old plan must be scrapped; a new one must be drafted. When circumstances change, you must readjust your plan. Keep a clear "road map" of where you are going.

## PLANNING ASSISTANCE

One of the most significant management tools in small businesses today is an advisory board. An advisory board for a small business should comprise at least three people, who, preferably, complement your own skills. It can be made up of an accountant, a lawyer, an outside consultant or CASE counsellor, other people in small business (not necessarily the same type of business), and perhaps one of your employees. You could reciprocate by sitting on the advisory board of other small businesses. The amount of time required to set up and use an advisory board is small compared to what you will get in return: the chance to discuss your plans, to consider alternatives, and to hear the experiences of others.

No one will help you with your problems if you pretend you haven't got any. Tell your board what is really happening. Express your plans and problems; other people in the same boat can offer good, and sometimes the best, advice.

No business is too small to have an advisory board. By not exchanging ideas with other businesspeople you are restricting your growth. It is good management to open your ideas to other experienced businesspeople who can help you by telling you that you are not alone in your plans and problems.

Using an advisory board comes back to the whole question of planning. Managing that plan means taking time to look at your problems and goals carefully, especially before doing something that will require a large outlay of money or effort.

Your staff may not necessarily be represented on your advisory board but they should not be excluded from your planning. Every department or person affected by a plan or a problem should be consulted, preferably through regular meetings. Once a plan of action has been decided upon, all employees should be included in the communications. After all, you need their support to make the plan successful. If you are increasing production or stopping the production of a certain money losing item they should know about it: when to expect it, and why.

## CONCLUSION

Good management means good planning. Planning need not be time-consuming and it need not be elaborate, but having clear objectives and establishing strategies will give your company direction.

Once you have a solid corporate plan, you can proceed to the next step in realizing your objectives — putting the plan into action.



## 2. Marketing

Introduction .....	page 26
What is marketing? .....	page 26
Developing a marketing plan .....	page 27
Marketing questionnaire .....	page 30
Marketing objectives .....	page 32
Developing the plan of action .....	page 37
Marketing alternatives .....	page 39
Marketing tips .....	page 39
Personal selling .....	page 40
Pricing .....	page 41
Advertising and promotion .....	page 42
Exporting .....	page 42
Evaluating and monitoring .....	page 43
Conclusion .....	page 44
Sources of information .....	page 45

# INTRODUCTION

As mentioned in the previous chapter, before you start to manufacture your product you should develop a corporate plan. This plan outlining your corporate objectives should include a marketing strategy as one of its key elements.

Whether yours is a new business or an existing one, a marketing plan should be one of your primary considerations. In the case of a new business, you shouldn't start manufacturing without having first undertaken a market study to determine the feasibility of your idea or product.

There are various sources of information that you can use in preparing a market study and you can never be too thorough. It is often helpful to have an outsider or a neutral third party assist in the market study, because you, as the innovator, may be somewhat optimistic about the market potential. In preparing a market study you must analyze your customers' needs, competitive products, and your capabilities. Generally you must have more than technical expertise to successfully manufacture and sell a product; among other skills, you must understand marketing.

In this chapter we will explore the various facets of marketing and we will cover the basics of developing your own marketing plan.

## WHAT IS MARKETING?

Marketing is the process of determining how you are going to get your product into the hands of the consumers you want to reach. It is not just a matter of manufacturing a product and then waiting for customers to come rushing in to buy, even if it's the greatest product in the world. Competition will not allow this. It is not by chance that some products sell well and others of comparable quality die for lack of interest. It is the marketing process that will help imprint your product in the minds of consumers.

In order to assure survival, your product should have some distinct advantage over the competitor's. This distinction could be made up of one or several factors:

- a superior product, which could be due to the quality of the technical aspects.
- a more efficient manufacturing process which produces fewer defects during fabrication.
- a management team that is alert to what is happening in the marketplace and tries to be one step ahead of the competition.
- a superior location, which can help you compete on both the timing of orders and price, since transportation costs can be kept to the very minimum.
- a better price, which can be the result of a more efficient manufacturing process, location, quality, value, etc.
- a more comprehensive service or warranty policy backing up your product.
- a more extensive or complete line of products.

## DEVELOPING A MARKETING PLAN

Developing a marketing plan follows the same logical steps outlined in the previous chapter. You must determine where you are now, where you want to be, how you want to get there, and if you are being realistic in your objectives. In setting up your marketing strategy you must systematically analyze your proposal:

- Where is your company in relation to today's marketplace? You must also assess the market penetration of your products.
- What do you want to achieve by a marketing program? You must set objectives.
- How will you get what you want? You must develop your plan of action and implement the strategy.
- How realistic are your objectives, strategies, and tactics? You must evaluate and monitor the results of your program.

## **Where does your company stand in today's marketplace?**

To begin your marketing plan, and to do it properly, you must first think about all aspects of your company. In fact, a marketing plan can plot the direction of your whole company. That direction should be based on what customers want and what the firm can deliver. You must not mislead yourself; you must be completely objective and honest in analyzing your firm's capabilities and how you want to achieve your goals.

## **How does your company compare in the marketplace?**

- Begin by analyzing the present. Define what kind of business you are in from a *marketing point of view*. If you manufacture furniture, you are in the business of helping people furnish their homes and offices. If you manufacture specialty furnaces, you provide heating systems for industry.
- It is important from a marketing perspective to recognize the distinction between what you do and what kind of business you are in. You must put yourself in your customer's position to see what makes your company a little different.
- List all of your products, their prices, and the quality of each product. Which products are most profitable? Are sales for the profitable products increasing or remaining constant? What percentage of your job quotations result in orders? Are your prices competitive?
- Describe your present image in the marketplace. Do customers like your company and are they satisfied with the merchandise? How is your company perceived by customers — as modern or old-fashioned? Do customer complaints come in frequently? Why? Is there a high rate of return on merchandise? Some of this information can be found in sales reports and return records.
- Draw up a mini-survey to find out what your customers think of your company product, service, reliability, advertising, technical know-how, sales staff, and product literature. Ask your customers directly or mail a questionnaire.
- Who buys your products? Analyze it by geographical area, types of customers, and number of individual customers. Are they in the industrial, business or commercial sectors? List other points which will

characterize your customers. Also look into previous sales enquiries which can tell you who your present customers are, and may also reveal a market you didn't know existed. Determine if you are becoming too dependent on too few customers or products. Ask yourself why your customers buy your product and why they don't buy more?

- Who are your competitors? Who is the market leader? Can you learn from the competition? List the companies, sizes, locations, popularity of products, what they manufacture, and the quality and prices of the products. Determine if they have a market advantage over your company, and whether you have the same customers.
- Try to determine your market share. Look into studies done by market research firms, business magazines, financial newspapers, the various levels of government, the Canadian Manufacturers' Association, or your own product association. Statistics Canada is another good source of information. (See listing of sources at the end of this chapter.) You should be looking for the number of companies in your industry (your competitors) and their annual sales. You can compare these sales figures to your own in order to determine an approximate market share. Has your market share changed in recent years? Is the market growing or declining? What changes are occurring in the marketplace and how will they affect your forecasted sales?
- Describe your present capability in all areas: production, sales, service, and financial.
- List sales and marketing approaches now in place and determine how successful they are. Do sales indicate a pattern by type of product, type of customer, or geographic area? What emphasis do you put on product quality, service, or price in your marketing approach?
- Consider the environment in which you operate. Often, there are conditions over which you have no control, but which you must be aware of as they can sometimes seriously affect your company's profits. These conditions would include changing consumer preferences,

government laws and regulations, inflation, interest rates, and technological changes, some of which could almost eliminate certain products overnight.

If you have answered these questions honestly and with sufficient information under each question, you will have the right kind of data to help you determine where your company stands, and whether that position is good or bad.

You may find several questions that are difficult for you to answer. It may be necessary for you to undertake some research with outside sources, customers, suppliers, etc., before you can determine a satisfactory response. This research will help you get to know your business better.

To help you in your analysis, use the following worksheet as a guide.

## MARKETING QUESTIONNAIRE

- What business am I in?

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- What are my products? Describe them.

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- What image does my business have?

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- Who am I selling to?

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- Who are my competitors?

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- What is my market share?

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- What is my capability in production, sales, service, and finances?

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- What sales and marketing approaches do I use now? Are they successful?

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- What environmental factors (in the workplace) must I be aware of?

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- You should also include a brief analysis of the various government regulations affecting your manufacturing sector.

Municipal:

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Provincial:

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Federal:

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## MARKETING OBJECTIVES

You should now have sufficient information on hand to identify your company's strengths and weaknesses. By studying that information you should be able to decide how you can build on your strengths and overcome your weaknesses. It is time to set objectives and establish strategies. Sales targets should be established and support programs should be planned. Think positively and be aggressive. Develop a plan that you honestly feel you can achieve with hard work and good management.

One of your weaknesses may turn out to be an image problem. For example, clients may perceive your company as being rather out-of-date even though your products are competitive. This poor image is more

than likely hurting sales in this modern, technologically-oriented society. As a result, your market share may not be what it could be.

In such a situation, your course of action is obvious. First, you must prove to your customers that you have an up-to-date product that will meet the needs of today's modern consumer. This, of course, will lead to a second objective of increasing your market share, which will mean a proportionate boost in sales.

One of the most important features of your marketing plan is determining how you are going to get the product from your plant to the end-user. The sale of some manufactured products may be directly from your factory to a certain number of dealers. This would require a larger sales department than if you were to sell to a distributor who would have his own dealer structure. As you can appreciate, if you are selling directly to dealers, you would sell at a higher sales price in order to defray your costs of maintaining a larger sales department. If you are selling to a distributor you can sell at a lower price because you don't have to maintain such a large salesforce.

Normally, the size of your business and potential markets will determine whether your sales chain is manufacturer/distributor/dealer or manufacturer/dealer/customer. In fact, some manufacturers have found it necessary to go directly to the customer in order to maintain an attractive retail price. You should be constantly aware of this trend and periodically review your marketing structure in light of your competition. It is obvious that if you are selling your product through the distributor/dealer/consumer approach and your competition eliminates the distributor, you may become non-competitive. You might have to change your distribution policy or cut your manufacturing costs in order to maintain a competitive price and retain your market share.

Once you have decided how to reach your new objectives, keep an eye on changing conditions that could affect your business. If there are changes, your objectives and marketing program must be revised and updated.

Let's examine a case where a small business has grown from a part-time basement operation into a full-time small manufacturer and is now at the stage where a marketing plan is definitely required.

*Terry Sanderson makes handcrafted furniture and small wooden items in a workshop behind his home, which is located on a main highway 60 kilometres from the nearest large city. He promotes these items — shelves, tables, cupboards, stools, benches, coffee tables, picture frames, and mirrors — by displaying them on his front lawn in spring, summer, and fall. In winter he relies solely on a large sign to attract customers.*

*Winters are much slower, as fewer people are out for casual drives. He uses this quiet time to build up some stock, but he doesn't want to keep too much inventory as he is never sure what customers will be buying next summer. People also buy on special order according to size, decorative elements, and colour.*

*During the quiet winter months of last year, Terry spent a lot of time thinking about his business. He is very proud of his work and he has been satisfied; but now, he wants more of a challenge. He decides that maybe he should try to expand the business and perhaps hire an assistant to help build up inventory. His biggest fear, however, is that even if he can offer a larger selection to his customers, he may not be able to generate enough new business. His customers are usually passersby and tourists driving through the province on the main highway. As far as he knows there isn't anyone near him who makes the same products.*

*Terry begins to think seriously about whether he could increase his production. If he were busy manufacturing, who would do the selling?*

Obviously, Terry is at a crucial stage of his business's development. But, before he proceeds, there are several key questions that he should be asking. What are they?

Some of these questions are listed below:

- What is the sales potential for the products?
- How large is the geographic market?
- Could the product line be expanded or improved to better satisfy customer needs?
- Who is the competition and where are they located?

- Are the product prices in line or should they be adjusted to be more competitive?
- What kind of distribution system is required to serve the larger sales volume?
- What kind of advertising and promotion is required to reach a larger clientele?
- Will new financing be required to meet these new objectives?

*Terry decides to go ahead and do some research on his own to see if his dreams are feasible and practical. He draws up a list of what he needs to know and where to find it. He checks the yellow pages of the telephone directory to locate potential clients as well as other manufacturers. Bringing a photo album of his products, he visits furniture stores, gift shops, and small and large retail outlets that now sell or have the potential to sell products such as his. He talks to salespeople, buyers, and owners. He also speaks to a cross section of consumers, distributors, and agents to get a better idea of the market. He tries to find out the following information:*

- preferred styles, colours, sizes
- prices
- where people shop and what do they buy?
- would volume discounts result in increased sales?

*Terry made an important discovery during his research trip. The majority of people he talked to expressed a lot of interest in the mirrors, picture frames, stools, and coffee tables but very little interest in the commodes and cupboards. He was somewhat disappointed because he really enjoyed working on the larger pieces of furniture. But why put all that effort into making cupboards when the demand is for smaller and less expensive items?*

*In effect, Terry had just completed a fairly detailed market survey for his business. Terry came back from his long trip with more than he had expected. Up to this point, his sales had been to individual, retail customers. Now, several gift shops, retail outlets,*

and some furniture stores had expressed an interest in his products. Too much interest. He wasn't sure that he could handle the production himself if all these potential new orders materialized. Then again, he knew enough not to overextend himself without first having definite orders.

The next day he sat down to do a sales forecast based on an estimate of the orders he expected to receive. After comparing this to last year's production figures, he realized that he would definitely need to hire additional staff to handle the increase in orders; however, he didn't think he could afford a helper right away. He would have to limit orders and control production so that he, possibly with a part-time helper, could manage. After carefully weighing all the factors, he came up with the following forecast.

#### **Forecast for next year**

Sales	\$40 000
Cost of goods sold	<u>20 000</u>
Gross Margin	20 000
Operating Expenses:	
Salary — owner	\$10 000
Overhead	800
Utilities	1 000
Depreciation — machinery	800
Depreciation — building	500
Advertising	1 500
Delivery expenses	2 000
Bad debt expenses	200
Business taxes	250
Insurance	500
Interest	<u>1 500</u>
Total Operating Expenses	<u>19 050</u>
Profit before taxes	<u><u>950</u></u>

**N.B.** Forecasting is more completely explained in Volume 1 of the "Minding Your Own Business" series.

After Terry's initial excitement over the market potential for his products, the forecast has helped him realize that he must be cautious in building up his business. The small profit that he forecasted could be used for loan repayments, to increase working capital, and towards the cost of hiring a part-time helper in order to build up more inventory. Once his first expansion year is over, Terry will have a firmer idea of upcoming orders and his business will be in a better position to meet the resulting production demands.

Now that Terry has prepared a preliminary forecast he might have a professional adviser (accountant, lawyer, counsellor, etc.), or a business friend look it over for an impartial opinion. This type of feedback is invaluable in preparing realistic plans for a business.

Now Terry should prepare a cash flow forecast for the same period of time. A cash flow will show when cash can be expected to come in and go out, and in what amounts. (Cash flow is also explained in Volume 1, "Minding Your Own Business.") In Terry's case, the cash flow will help when he approaches his banker for financing. The cash flow will show that there will be sufficient revenue to make loan payments and it will also indicate peak times of the year when Terry can afford to hire a part-time worker.

With all this information Terry can now make an intelligent decision about what to do. He decides to go ahead, knowing that in the first year not only will he take a cut in salary but he will have to work extra hard to produce enough items to fill orders.

Now, after completing his initial market survey and preparing the relevant forecasts, Terry is ready to develop the strategies for his marketing plan.

## **DEVELOPING THE PLAN OF ACTION**

Terry's plan of action is a simple one, but it meets the needs of his small manufacturing business.

- He will cut his salary in order to keep costs under control.
- He will develop a marketing strategy to obtain new orders from gift shops and small retailers rather than approaching the large volume

retailers. He will go after the larger orders later when he can afford to hire a full-time helper and when his new production and distribution systems are working smoothly.

- He will use a distributor to build up his wholesale business to smaller stores.
- He will investigate the costs of developing a logo for his company, which will be used on all stationery, bills, calling cards, catalogues, and in advertising. He wants the logo to be a simple one that is not identified with only one product. This way his logo will not become outdated if he were to expand his product line.
- He will prepare new catalogues, for himself and the distributor, with full-colour photographs to illustrate the various products and styles. These will be in a loose-leaf or album format so that he can easily update them as his business grows. The catalogue will include all specifications including finish and dimensions. A separate price list will also be prepared.
- He will complement the sales efforts of the distributor by placing advertisements in local newspapers to announce that his products are now available in certain stores. He thinks he may be able to offset his costs by getting the stores to pay a portion of the advertising costs.
- He will rent exhibit space in some handicraft fairs and local expositions to promote his business. He also will donate one of his products to a local charity as a prize in an upcoming raffle.
- Terry also decides to offer a warranty policy against warping, splitting, or loss of rigidity in any of the products he manufactures. He has been very careful with his purchases of dry, seasoned lumber so he doesn't expect to have many problems and this type of policy shows that he plans on being in business for a long time to come.

Terry has now established, in writing, the major strategies in his marketing plan. He is going after new markets and he has outlined how he expects to reach those markets. Any small manufacturer could establish similar strategies to develop a new product line or expand an existing one.

## MARKETING ALTERNATIVES

Depending upon your requirements, there are four basic alternatives to consider in defining your marketing plan. Each plan has specific strategies that need to be developed to ensure its success.

- Intensify efforts to market existing products in existing markets. If you think that your present strategies are successful, you may simply want to increase their intensity. You might increase your advertising or make more sales calls. If you don't have a definite marketing strategy then it is time to develop one.
- Identify new markets for existing products. For example, Terry, our small furniture manufacturer, moved into the wholesale market. You have several options such as opening up a new sales territory, selling through more distributors, or moving into the export market. (The export market is discussed later in this chapter.)
- Extend your product line to improve your sales in existing markets. Make improvements by adding new colours, styles, and sizes, if applicable. Based on customer contacts or a market survey you may develop a new product for the existing market.
- Develop a new product line for a completely new market. This option has the most risks and the decision to go ahead should be based on solid research no matter what the product or market.

## MARKETING TIPS

Now, as discussed in the previous chapter, you should prepare a marketing plan which outlines a program of action with specific strategies and schedules. Each strategy should be carefully considered according to objectives. Be sure that each marketing strategy has been included in the present corporate plan and forecasts as discussed earlier. Consider whether you have sufficient staff to make new sales calls and meet increased production quotas. Consider how much it will cost and if you have sufficient finances to carry it out. How will your present customers react to your new plans?

## Personal selling:

A good marketing plan usually calls for a blend of personal selling and advertising. A good plan will also be based upon what the *customer wants* rather than just on what the firm wants to sell or wants to produce.

Salespeople can be valuable allies here. They can be the key in helping you to determine special needs of customers. If you use a distributor or agent, then you must be able to trust them to give you the same kind of information and to sell your product with as much enthusiasm as one of your own salespeople.

Make sure that you provide your sales team with all the backup information they need. This means training them properly on the pros and cons of your product and how to best represent it. Make sure they know why your product is a better buy than the competition's. Each salesperson should have a product catalogue and a specification sheet. Provide brochures or a give-away item that can be left with potential customers.

In addition to a sales catalogue, another popular tactic that helps customers see and understand your product is the use of slides. An accompanying script will point out how good your product is, and how it will save your prospect time and money. Depending on the product, this type of presentation could be made to several prospective buyers at the same time.

If you have a large sales team or several distributors you could create a sales contest as an incentive to increase sales. Also, make sure your sales team understands the importance of after-sales service. Whether the customers are consumers or retailers, they will appreciate an interested salesperson.

Trust is especially important in industrial selling where price, looks, and colour are not the only factors affecting the purchaser's decision. How the product will fit into what the customer has, how well it works, and how reliable it is are equally, if not more, important. If you have a product that comes in a variety of sizes, then perhaps you can offer an assortment of sizes at a special price.

If you manufacture a type of machine or a moving component, develop and sell a service kit for customers. When something needs repair,

it saves time and expense when the customer can do it immediately. Depending on the product, you might also develop a service policy.

**Pricing:**

Often neglected as a marketing strategy, pricing is something that should be weighed very carefully. Too high a price will put you out of the market, while too low a price will undervalue your product and probably result in a loss. It is important to remember that a higher price does not necessarily mean higher profits, as volume is likely to taper off at a certain price level. A simple price/volume/profit calculation can be made to establish the parameters for your product price.

When establishing your price you should take into account several factors:

- What does the customer consider a fair price for the product?
- What quality or amount of “extras” have you built into your product over your competitors’?
- What is the price of the competitive products?
- Does your pricing policy take into account volume purchases and pre-determined payment schedules?

A hypothetical example of a price/volume/profit calculation is given below.

Unit Price	X	Units Sold	= Revenue			
			Revenue	- Variable Costs	- Fixed Costs	= Profit
\$100		65	\$6 500	\$3 250	\$1 000	\$2 250
90		85	7 650	4 250	1 000	2 400
80		100	8 000	5 000	1 000	2 000
70		120	8 400	6 000	1 000	1 400

In the above illustration we have shown a situation where a price that is too high results in a drop in volume that reduces profitability. A low price, although resulting in a larger volume of orders, does not cover enough costs to make it a profitable decision.

## **Advertising and promotion:**

A marketing plan isn't complete without an advertising and promotion strategy that is directly related to the sales objectives. The type of advertising and promotion campaign depends on the product and the market. If you are aiming at the consumer market directly then your choice of media may include TV, radio, newspapers, etc. If you are strictly wholesaling then you would probably stick to trade publications and concentrate on promotion activities such as trade fairs and point-of-sale literature or give-aways such as pens, calendars, etc. Direct ad-mail is a useful strategy if your business volume warrants it.

If your product has news potential either directly (as an innovation) or indirectly (by association), you should inform journalists who may be interested in preparing an article on your business.

Most importantly, when preparing press releases or advertising copy, be sure that the copy is accurate, well-written, and well-conceived. It is a good idea to consult professionals if you are launching an advertising campaign. Not only will they assist in choosing the right advertising medium they will also help you get your message across in a professional manner.

All these aspects of advertising and promotion must be timed to coincide with your sales objectives. By planning ahead, you can ensure that your ads appear at the right time and in the right place. An ad placed after the season has peaked or after a major promotion by a competitor will not yield as successful results.

Market planning is a challenging job. Consumers have a wide variety of demands and many potential sources of supply. Your plan (goals, strategies, and tactics) must satisfy those demands in order to find a niche in the system for your firm. In other words, in today's increasingly competitive market, a good strategy is needed for success. It's difficult to increase your market share using yesterday's strategies. Think of new and innovative ways of meeting your clients' needs.

## **Exporting:**

When thinking about market expansion, you shouldn't overlook the possibility of exporting. Often, small manufacturers consider the

export market as being beyond their reach, and only for the big guys. In reality, however, exporting presents significant opportunities for the small manufacturer.

For Canadian manufacturers perhaps the most obvious export market is the United States where there is nearly 10 times the population. Also, the Canadian dollar is usually lower than the U.S. dollar which is a benefit to the exporter, and there aren't the same language and culture barriers that exist in some other export markets, although these shouldn't be a major deterrent.

If you think you have a product that could sell in the U.S. or other foreign markets you can begin by doing your own market study or, better still, approach your federal and provincial government agencies where many programs exist to assist the smaller exporters. There is no point in copying what is already available within the foreign market unless your product is substantially less expensive or of a higher quality. In order to compete, you must have something different, original, of a better quality, or for a better price.

Don't think about export markets unless you have a firm footing at home. Exporting only to get rid of some excess inventory will hurt you in the long run as you may not have the production capability to meet future orders. Exporting requires at least as serious a commitment as domestic marketing and generally represents increased costs such as freight, insurance, packaging, etc.

Government sponsored trade shows can be an excellent means to offer your products to foreign buyers. It's important to know your market and be well-prepared when you are considering exporting. The federal Trade Commissioners' Service can provide information about trade regulations and opportunities in countries around the world.

Exporting may require a little more paperwork but it often can result in significant rewards for the smaller exporter.

## **EVALUATING AND MONITORING RESULTS**

Once you have established your marketing plan and defined your strategies, you may find it to be out-of-date the minute it's finished due to unpredictable factors like a new competitor or changing market

conditions. But if you have followed the steps outlined in the previous chapter you should have alternative plans of action for such emergencies.

Generally changes don't come so suddenly that you can't prepare for them. You must establish procedures to monitor your progress at regular intervals. You will want to ensure that cost objectives are being met, that sales are meeting your targeted figures, and that customers are responding well to your new advertising campaign. If you like, prepare a chart in your office to keep track of your progress and to give your staff the opportunity to see the results of their efforts.

If you notice that sales are not increasing or that your customers have switched to the competitor's product, a corrective marketing plan should be implemented immediately. Keeping track of your results in relation to your sales budget is important. Costs that get out of control can affect your results just as easily as a drop in sales can. Why risk losing the position you have built for yourself in the marketplace?

Monitoring your marketing plan on a regular basis involves looking at several key areas:

- actual sales compared to budgeted sales
- control of receivables
- new orders
- back orders
- inventory levels
- advertising campaign
- promotion activities
- market share
- production schedules.

## CONCLUSION

Marketing is a fundamental activity in a successful manufacturing operation. If you are fortunate enough to have products that sell themselves then think of the increased profit potential if you were to provide the backup of a marketing plan. Establishing a marketing plan that supports your overall objectives will be a big step towards ensuring your company's position in the marketplace.

In this chapter we have discussed the essential ingredients of an effective marketing plan:

- an effective analysis of the present situation
- an accurate view of where the company is headed
- a perceptive interpretation of where the company should be headed
- development of concrete strategies to achieve the objectives
- a systematic evaluation of the company's progress

These are the basics of a successful marketing plan and a well-managed, profitable business.

## SOURCES OF INFORMATION

The following list includes some government departments, publications, and associations that may help you not only in your information research for marketing, but also in all aspects of your business. There are others, so check your local library and ask your business colleagues.

**Financial Post Survey of Markets** This is an annual publication that provides a statistical overview of potential markets in Canada. A wide variety of information is provided such as Consumer Market data giving population projections, number of households, personal disposable income, and retail sales. Another section — national market survey — gives a detailed breakdown of marketing factors by area: population, households, ethnic groups, personal disposable income, building permits, housing starts, manufacturing statistics, etc. The media data section provides media facts on Canada's major metropolitan areas. A national industrial survey covers the economy on a national level, giving current details on national income, foreign trade, employment, wages, and prices.

**Special Market Studies** The Financial Post also produces several special market studies. The **Survey of Industrials**, for example, reviews more than 1 200 Canadian companies engaged in manufacturing, sales, and service industries, with details on operations, management, and financial status.

**Maclean Hunter Research Bureau** Maclean Hunter also produces

several studies on specific industries. Among them are the **Canadian Electronics Market** and the **Office Equipment and Supplies Market in Canada**. The booklets cover information on all aspects of these markets.

**Canadian Trade Index** The Canadian Manufacturers' Association publishes this large volume that lists many of the manufacturers in Canada (both members and non-members). The Index consists of an alphabetical listing of the manufacturers, a list by geographical area and by product, as well as a listing of trademarks.

**Private Market Research Firms** You could probably get the kind of study you need from one of the many private firms around. You should also check your local business schools, colleges, and universities. These sources can usually design and conduct studies that are specific to your needs.

**Chamber of Commerce or Board of Trade** A very helpful booklet published by the Canadian Chamber of Commerce is **Sources of Information for Canadian Business**. The booklet covers a range of topics from how to conduct an information search to listings of the different types of information sources.

**Directory of Canadian Trading Houses** If you are considering export markets, this provides a detailed listing of trading houses by type of products handled, country of destination, and location in Canada.

**Provincial Departments of Industry** If you are specifically interested in one province try this department. They have various kinds of business and economic information about activities in the province.

**Federal government departments and agencies** Federal Business Development Bank branches provide details on government assistance programs and can also suggest additional sources of information. A management counselling program, CASE (Counselling Assistance to Small Enterprises), can provide a counsellor to help with your market studies at a modest fee.

Export assistance is available from departments in the federal and provincial governments. Information on export opportunities and import replacement is available.

BOSS (Business Opportunities Sourcing System) is a computer database identifying Canadian companies and suppliers for international and domestic markets. Your company can be listed at no charge.

Specific departments such as Agriculture Canada, Fisheries and Oceans, etc., have market research information relevant to their sector.

**Statistics Canada** This is an important source of data for every businessperson. Statistics Canada has recently made it easier to use their services by publishing a series of booklets which list the kind of information available, and how to use it.

Of special interest to small manufacturers is the booklet, **How a manufacturer can profit from facts**. You will find information on introducing a new product line, plant expansion, and finding and using statistics.



# 3. Production

Introduction .....	page 50
Production guidelines .....	page 52
Choosing machinery .....	page 53
Production flow .....	page 56
Plant layout .....	page 59
Employee performance .....	page 63
Scheduling .....	page 65
Quality control .....	page 66
Production Control Board .....	page 70

# INTRODUCTION

In general, manufacturing can be described as standard manufacturing, custom manufacturing, or production-line manufacturing.

Standard manufacturing describes operations where a standard product is produced without requiring several stages and machines.

Custom manufacturing can be characterized either by small quantities produced in a shop at one time, or by a large variety of models and sizes of the same product. If we go back to our example of Terry in chapter 2, our manufacturer of wooden items for the home, we have a custom type operation where a few products were made for roadside sale based on demand, while others were special customer orders with individual specifications according to size, style, and colour. Custom manufacturing usually depends upon highly skilled people or craftsmen. In Terry's case, each piece was built by one woodworker who saw the product through to completion. If the business eventually grew to the point where two new employees were hired, Terry would have the choice of either hiring two highly competent woodworkers or hiring one highly skilled and another who was basically unskilled in the finer aspects of woodworking. In the first case, each employee would begin and finish a job whether it were a table, chair, or shelf; one person would be responsible for the majority of the work on one piece. In the second case, the unskilled worker could do the rough work while the skilled cabinet-maker could concentrate on the finer aspects of assembly and detail. Custom-made products are usually more expensive to produce and, therefore, generally have higher selling prices. Also in this type of small custom shop, employees can leave their particular job to help a fellow employee without disrupting the production flow.

In a production-line type of organization, employees perform a repetitive sequence of manufacturing tasks, which results in the product being completed in several stages. A production-line operation can be more cost efficient on a per-item basis because it allows for increased output as employees become more proficient at performing their individual tasks. This differs from the custom operation where a variety of skills must be mastered to complete all stages of production.

The following is an example of a production-line manufacturer which we will be using to illustrate various sections of the text:

*The XYZ Boat Manufacturing Co., which manufactures small aluminum boats, produced 5 000 boats last year for annual sales of \$1 600 000. The company manufactures boats all winter, according to a marketing plan, and begins to ship to customers in the spring.*

*There are about 30 employees in production, including those in parts, assembly, and loading, and 10 employees in administration, buying, and selling. One of the salespeople is a troubleshooting engineer who inspects any client complaints regarding the boats. "XYZ" uses distributors to get the boats into retail outlets and hunting and fishing lodges. The majority of sales are in the northern part of the province and the North West Territories.*

*The boats come in six models, ranging from a very basic boat to one that is larger and has such extras as a folding windshield, swivel seats, and carpeted floors.*

*"XYZ" has been in business for fifteen years and has developed forecasts and plans that show a steady growth in profitability over the next few years.*

Using our boat manufacturer as an example of a production line where employees perform repetitious tasks, the initial preparation of the aluminum sheet (shearing, routing, and riveting) is done by two or three people who do nothing else. The second stage is the initial production of the boat form by other employees who subsequently fit the aluminum sections. The third stage is the installation of extrusions, castings, seats, etc.

Generally, the type of product manufactured will dictate whether you set up your operation as a custom shop or a production line.

Contrary to the situation in a custom operation, if an employee in a production line stops or leaves the workplace to help someone else, it disrupts the flow of work on the entire line. One employee missing from

a production line can cause a disruption. In the example of the XYZ Boat Manufacturing Company, if one of the two boat cleaners normally required for the job is away, the work will pile up and become too much for one cleaner to handle. In a larger operation the completed boats would soon begin to block the entire operation, leaving some workers standing around idle. In a small non-union shop other employees could help with the cleaning, but production would still slow down.

A production line consists of workers who each have one particular function to perform. They may or may not be highly skilled. Some of them can be trained on the job and others may require specialized training.

The most basic decision before starting a production line is whether the work comes to the worker or the worker goes to the work. In small firms, the constraints of moving an item or installing a mechanized assembly line may be impractical and too costly; therefore, it may be more effective to have the workers move to the products.

Production-line goods are usually less expensive to produce and less expensive to the consumer than products from a custom operation.

Some manufacturers use a combination of both methods. Often, a custom shop will grow into a production-line operation when it becomes so large that it is impractical and too expensive to continue a custom operation. It is important, however, to maintain the quality and service that allowed the company to grow.

## **PRODUCTION GUIDELINES**

Whatever type of manufacturing is used, there are universal production guidelines. These guidelines will be discussed in this chapter under the following headings:

- choosing and using the right machinery
- production flow
- plant layout
- employee performance
- scheduling
- quality control

Most of the guidelines apply regardless of the size or type of manufacturing. In some instances clarification will be made between custom and production-line manufacturing.

## **Choosing and using the right machinery**

Choosing machinery is one of the most important decisions you will make during the start-up of your company. The type of machinery that you initially choose will be important when the time comes to expand or to update your manufacturing process. A wrong decision can adversely affect the future of the firm because some machines will become obsolete more quickly than others. Machinery is much too expensive to be purchased without carefully considering all the options. Purchasing requires careful planning before you go ahead. One of the most important considerations is future adaptability, i.e., buy the machinery with both your present and future needs in mind.

First take your total manufacturing process and the number of machines you will require to complete it. Reduce each step (or machine) to the degree of tolerance you will need, and then look for machines that will give you two or even three times the required tolerance. Also, don't forget to weigh the factors of speed, capacity, and versatility very carefully.

Even in a simple operation like Terry's woodworking shop it is advisable to think ahead when buying equipment or machinery. For example, a hand-held drill will satisfactorily drill holes but a drill press will do the job with more accuracy and in less time. Although it represents a significant difference in cost it will also mean that Terry will be in a much more flexible position when it comes to accepting new orders. One special order might pay for the drill press.

In a more sophisticated operation requiring the purchase of expensive, precise machinery, the choice of equipment will have a lot to do with the plant's output. In this type of operation the machine must be able to meet and exceed the specifications required by the design. If, for example, the specifications required by your design call for tolerances of  $\pm 1/10\,000$ ths of an inch, your machine should be capable of manufacturing to a higher tolerance of, for example,  $1/15\,000$ ths of an inch with repetitive accuracy. If you buy a machine that meets only your

basic tolerance, you may have a higher than acceptable rejection rate. The additional accuracy is necessary to manufacture a product that meets your specifications with a tolerable rejection rate. Cost effectiveness has to be considered at this point. A machine which might cost \$50 000 when it has an accuracy of + or - 1/10 000th of an inch may well cost twice as much if you want a higher tolerance of 1/15 000ths of an inch. You might find, therefore, that the additional investment in the capital equipment does not justify the difference in the percentage of rejects of the two machines. On the other hand the additional cost of the more sophisticated machine could be recovered over a period of time by the savings made in lowering the number of rejections.

In preparing such a cost effectiveness analysis one of the crucial factors is the expense of the raw material. If either the cost of the raw material or the rework costs are high then the acceptable level of rejections would be lower than if materials were less costly.

Buying equipment or machines of higher calibre will generally provide the following benefits:

- better accuracy
- savings in damaged materials
- less stress on your machines
- fewer equipment failures
- increased capacity
- higher production speed
- more versatility

In our example of the XYZ Boat Manufacturing Company, one of the required machines is a 12 ton shear which cuts the aluminum (rolled up in coils) to the required length.

As an example, the cost of the shear could vary depending on the level of tolerance required from \$50 000 with a 1/4" tolerance, to \$75 000 with a 1/16" tolerance.

By purchasing the machine with the higher tolerance "XYZ" would reduce the number of rejects and probably recover the extra \$25 000 spent on the more expensive machine.

The cost effectiveness could easily be calculated by comparing the cost of borrowing the extra \$25 000 vs the cost of the estimated 10 per cent rate of rejects they would likely get with the less accurate machine.

\$25 000 + interest for five years

vs

Reject cost of both a 12' and 18'\* piece of aluminum at a rate of 10 percent over five years. Reject cost includes material cost (less the scrap value), labour, disruptions to the production line, and lost orders.

\* The 12' length of aluminum is required for a smaller boat, while the 18' length is required for a larger model.

This type of cost effectiveness analysis is an invaluable tool when you approach your bank manager for financing to buy a machine. The bank manager will probably want to know why you cannot buy a less expensive machine. If you have the figures to prove *why you cannot afford to buy a less expensive one*, you will leave your banker with the impression that you have considered the alternatives very carefully. Also you can point out in your presentation that this machinery will give you the capacity for the increased production and versatility that you have planned for, with a minimum amount of extra capital investment.

Sometimes the cost of a more sophisticated piece of equipment cannot be justified when all the factors and benefits are considered. Re-evaluate the situation as your business grows, and as the economic situation changes.

You shouldn't eliminate the possibility of either leasing equipment or acquiring second-hand machinery through auction sales and dealers. Second-hand machinery or equipment may be a viable alternative simply due to its availability; new machinery can often have a long lead time for delivery. Finally, your cost effectiveness analysis should include how much it would cost you to subcontract the work. In the case of our woodworker, he may not need to invest in an expensive lathe if he can subcontract his turning work to someone else. This represents a saving in capital and also would help speed up production time while allowing Terry to concentrate on the important aspects of assembly and finishing, in addition to developing new markets for his products. This "make or buy" decision is an important element in all small and medium-sized manufacturing businesses.

The right machinery for your plant is not always the most expensive or the latest model on the market. A new model may need a few years before the manufacturer works out any faults in the design.

Each situation is different and sometimes it is better to buy the traditional, standard models. They are often more reliable, and you may eventually make a trade-in with the same manufacturer when the time comes to upgrade your equipment. Some manufacturers like to buy all their machinery from the same manufacturer because spare parts are often interchangeable.

Also consider the life expectancy of the machine and whether it is adaptable, so that you will be ready if the time comes to increase capacity.

Before you actually make a purchase, ask others who use the machine what they think about its reliability and the company's service policy. Verify what the salesperson has told you. Your local trade association may also be able to give you some advice.

You should always be aware of the "state of the art" as it relates to your particular product line. Wherever possible, you should try to buy production machinery that lends itself to upgrading as your manufacturing process demands. If you have a competitor who has the capability of increasing production capacity and product market acceptance because of more sophisticated equipment, you may be in trouble in a few years. You could soon find yourself in a noncompetitive position simply because you bought machines that were obsolete or already at their peak in being able to meet your product specifications.

There are other important considerations when buying new machinery before you start up a new business or move to a new location. You should ensure that the utilities and other services you require are readily available at your chosen location. If not, you may have to modify your machinery. If you do have to convert your machinery or upgrade existing services, consider it as part of your costs.

## **Production flow**

Heaven for any manufacturer is a continuous flow of work. An ideal situation would have production capacity working at the maximum

without any costly interruptions. Such a situation may be unattainable, but it is the ultimate goal when planning work in a manufacturing plant. In a production line operation it is the owner's task to try to estimate an equal workload for employees, so that no individual can impede the efficient flow of a product from the beginning to the end.

As discussed earlier in this chapter, the manufacturing process can be custom, standard, or production line. The custom type of manufacturing operation would probably arrange their shop by machine process or type. This way the plant is better organized and has greater flexibility to meet the requirements of small custom jobs. In a production-line operation the machines are organized in order of use for production of a particular product. This is the most efficient process for the standard product type of business but it has very limited flexibility to accommodate custom jobs. Costs will be incurred in scheduling and materials handling as well as by delays due to failure of equipment in the line.

Some smaller shops set up their equipment so it can be moved around to accommodate special jobs. This gives you the flexibility to customize your production line, thereby increasing your efficiency.

In the next few pages we will discuss production flow in our example of the XYZ Boat Manufacturing Company. Although many of the principles discussed relate to any size or type of manufacturer we have chosen the production-line type of operation, as it can be used as an illustration for virtually all aspects of the production process.

To get a production-line system working well requires a period of adjustment. After initially determining how the work will progress from station to station, there may be several revisions before the production flow can be maximized.

Personally observe the operation and keep track of what is happening. When you see that something is wrong or could be improved, correct it immediately and keep a record of these changes.

Although work is said to flow in a production line and to be static in a true custom operation, efficiency is still the aim.

Production efficiency will depend upon these factors:

- plant layout
- materials handling

- experience of employees
- capability of equipment
- adaptability of employees to new small tools or new techniques
- efficiency of machinery

You must remember that machinery does not function at 100 percent capacity all the time. Often you can't achieve a perfect production balance between a series of machines, or machines must be shut down every so often for maintenance and to set them up for the next job. This unproductive shutdown may total perhaps 5 percent of productive time if normal preventive maintenance is done during each shift. Other routine maintenance can often be conducted during inactive periods or on weekends and holidays.

Overcoming setbacks in your production flow is a constant challenge. Planning around them is your solution. Our aluminum boat manufacturer introduced one solution to the problem of balancing machine performance. Let's look again at the example:

*"XYZ" requires several major machines in their operation: a decoiler (to unroll the coils of aluminium), a shear (as mentioned previously), a router which cuts the aluminum to a pattern, and forming equipment.*

*The plant is divided into sections: the first is for the storage and distribution of materials, the second for cutting and assembly, and the third for cleaning, painting, and inspection. Another section is for storage of the finished product. The task of balancing machine performance comes in the second section, the cutting and assembly area.*

*The problem that "XYZ" had was that the router cut patterns for the boats from 12 sheets of aluminum at once, while the shear will only cut one sheet at a time from the coil. As a result, the worker on the router is idle a lot of the time while the shear operator is overworked. The solution introduced by the company was to have the worker on the router help the shearer at times, so that enough sheets were cut to keep the router loaded. In this case*

*the router is shut down periodically, but the worker is not idle and is helping to build up a continuous flow. The shearer's work progresses a little more quickly with the co-worker's assistance and there is the added advantage of the worker on the router being capable of doing both jobs.*

It is extremely difficult to lay out a production line so that all the machines are operating at capacity. As in the above example, some machines may be idle for part of the day; however, increasing the capacities (machines and manpower) at the other stages of the line may be too costly, especially if it results in an increased product cost that is unacceptable to the market.

A machine that is not operating at full capacity can still be economically viable, provided it meets the following conditions:

- it is absolutely necessary in your operation
- it cannot effectively be replaced by any other means
- it reduces your percentage of rejections

Production lines can only operate as quickly as the slowest machine (or worker) in the line, and production efficiency is maximized by combining several factors: an unimpeded flow of work, the lowest possible rate of rejects, the least expensive method of product assembly, and optimum operating conditions. The interplay of other factors, such as plant layout and employee performance, has a crucial influence on the workflow.

## **Plant layout**

The appropriate plant layout for your operation is a major contributor to an unimpeded work flow. It is important to ensure that materials and products flow easily in the assembly area, and that employees can move about the plant as they need to.

If unfinished materials are allowed to pile up for various reasons, it becomes difficult to move around. Safety considerations are also

important; it can be dangerous and costly, as in the case of a fire, where lives and materials could be lost.

If materials cannot get to the production assembly area, production will naturally slow down or stop. Labour and machinery stand idle, the whole plant becomes disrupted, and costs rise. In production, all systems are interdependent.

There are two main reasons why materials may not reach the assembly area: poor plant layout, or poor organization and scheduling of materials and supplies.

Plant layout is extremely important for the efficient operation of your business. Whether it's a large or small business, the organization of machines and people can have a crucial effect on productivity. Some phases of the operation will require more room for workers to move about, and some need to be flexible to allow for secondary equipment to be brought in from time to time.

It is difficult to outline a good assembly line design because each plant and product is different. Before you approve or implement any design affecting the movement of materials, it should be sketched, resketched, and reviewed several times until you feel it is perfect. The right design will allow production to flow from one phase of the assembly to the next without any difficulty. It is also one where materials are within reaching distance of the assembly worker; otherwise, the employee wastes a lot of time moving around in search of materials. For example, workers who put rivets in boats on "XYZ's" production line should always have a bin of rivets right next to them. It is the responsibility of the person in charge of materials to make sure those bins are always full, so that the worker does not have to ask for the rivets, thus losing time and holding up the line.

This principle applies equally for production line and for custom. In some custom shops the workers must go to get materials, but not always. It is the responsibility of the foreman or supervisor to be aware of what is happening in the plant at all times. Through personal observation and good judgment an inefficient situation can be corrected.

The supervisor is also responsible for getting materials to the assembly area on time. If production of 500 14' boats is to begin at

9 o'clock Monday morning, the materials department should have received the materials at least a week before. The machinery should be set up on the Friday. At 8 a.m. Monday, the aluminum coils should be ready to be cut and the other necessary materials and supplies on hand. The flow must be constant, job after job.

Some general principles of plant layout are outlined below:

1. When looking at a new space ensure that it will accommodate not only planned initial operations but also anticipated increases for the foreseeable future. Also, make sure that the layout of the plant is flexible enough to accommodate small orders or special jobs; it is this flexibility that gives small businesses the edge over larger competitors.
2. The placement of any large machinery requiring supportive pads should be carefully analyzed in relation to the total operation (assembly area, materials, etc.). The actual position of the machines has a great influence on the inter-plant movement of partially finished goods. Minimize it here. The layout should allow the easy rearrangement of the more movable equipment.
3. Ensure adequate employee comfort and support, such as lighting, washroom facilities, eating areas, and other amenities. These should be designed not only to provide the most comfortable location, but also to cut down on internal movement.
4. Ensure that the plant layout, machines, and systems adhere to all safety, environmental, and government regulations.
5. In some cases the owner is faced with setting up production of all or part of the operation in an existing plant. In this instance the above principles should also be accommodated. When the existing plant must be extensively modified to accommodate these principles, you must be sure that the end results will justify the expense and effort.

Another basic decision you will have to make with regard to work flow is whether the job goes to the worker or the worker goes to the job. Usually the size of the product or the production volume will determine the solution to this question; however in smaller operations it could often be either way. It is best to calculate which method will cost the least or which method will give you a higher rate of production. This can be partially determined by what product you are manufacturing.

*For example, let's assume that your company needs to install material moving equipment such as a conveyor system. The conveyor system you want costs \$8 000, and it should handle the planned expansion over the next ten years. But you don't want to be paying for it for the next ten years; expenditures for equipment such as this should have a reasonable pay-back period of no more than three years. Too many changes can take place over a longer period.*

*In this type of situation you need to consider the following variables:*

- cost
- market situation
- effect on productivity
- effect on long-term capital requirements for other fixed asset purchases

*The wrong decision could seriously affect your company five years down the road. You could decide against the expenditure because you don't want to overextend the financial resources of your business, but you may end up in a noncompetitive position. Modernization — not only of equipment but also of working systems and production techniques — is part of the life of today's manufacturer.*

*Caution is required here. Do not get locked into a production system that is inflexible. It is not wise to spend \$8 000 on a new conveyor system unless you are certain the market for your product is strong. It is more than just making a decision as to whether you can afford it; look for justification.*

Finally, when choosing a new system look at the following:

- maintainability
- ease of modification for modernization — can it be partially or fully adapted later, and for how much?

- compatibility with other machinery
- impact of the system on your employees' and your plant's productivity

## Employee performance

It is up to you, as management, to establish the production standards for your employees by using standard industrial figures or by carefully appraising the performance and output of several employees. You must provide the environment and initiative to keep employees motivated and working to the best of their abilities. (See chapter 5 for more details on personnel management.)

Explain your production flow to your employees: tell them how it works, and how it should work on a continuous basis. Encourage them to make suggestions that will improve safety, efficiency, or productivity. Employees enjoy having the opportunity to improve their work situation. In a way, they are monitoring themselves by watching out for situations that should be changed or corrected. When properly encouraged, employees will notify their supervisor or plant manager when any deviation in the production sequence occurs. They will automatically make observations which might improve production. It is important that you acknowledge all suggestions from your employees to assure them that the company cares about their suggestions — this also has an important effect on your plant productivity.

To ensure that job steps are not overlooked by the employees, many manufacturers use work charts. Work charts are another way an employee participates in the in-process inspection.

Employees should have a checklist posted beside them, where it is clearly visible, outlining how they are to perform their jobs. The work chart is especially beneficial to new employees, and can be used as a checklist in a situation where work is substandard. In this latter case, the individual should be judged on the work description only.

A work chart can be as simple or as complex as you want it to be. Often it will include the expected production rate and the quality control procedures to follow.

For example, a work chart for a riveter on the aluminum boat assembly line might be as follows:

### **Riveter**

- ensure correct rivet size is used:  
size 1 for small models  
size 2 for large models
- insert rivet into hole
- check to see if it is snug
- rivet it
- if the rivet is crooked, the boat may leak. Check with supervisor if you are not sure. If the rivet is crooked, punch it out and put in a new one
- complete all rivets in this manner  
  
450 rivets for small models  
700 rivets for large models

**Remember:** Quality will result in sales; and sales will affect **our** profits.

Once Terry gets his woodworking shop into full gear, he might prepare a work chart to be used by part-time workers assembling tables:

### **Table Assembly**

- check fit of all joints on table base
- apply glue to both mortise and tenon on all joints
- assemble base
- apply clamps
- attach top
- let glue set (30 minutes)
- check for any rough spots and fine sand if necessary
- wipe with rag
- apply finish coat

## Scheduling

Scheduling is a dynamic function that requires flexibility on the part of the company and the employees. Especially in a small business, situations that will upset the routine weekly production schedule can develop quickly. Factors affecting a production schedule include changes in the marketplace, the availability of personnel, the availability of materials, and the performance of equipment.

Scheduling is the responsibility of management. It requires the input of senior production people, the purchaser, marketing and sales staff, as well as senior management. In a small operation all of these responsibilities may fall on one or two people, but it is necessary that everyone be involved and advised. Strive to keep on top of changes so that you will have enough time to react, get to your suppliers, or cancel orders. See the example of a production control board at the end of this chapter.

### Some scheduling pointers:

1. Schedule your purchasing and production according to your master marketing plan, to ensure that raw materials and semifinished goods are available when required. But make sure that the inventory is tightly controlled because you don't want to be caught short, nor do you want to be stuck with costly inventory which may take you a long time to dispose of.
2. Establish production standards which provide a benchmark for material requirements, production labour, and support functions (loading, transportation, etc.). The schedule for production, loading, and shipping should be posted on a scheduling board. The board should show the status of all work orders and their expected completion dates. Day-to-day information on finished goods can also be put on a schedule board. Whatever type of board you choose, it should be easy to change or revise so that any new information, such as production problems, can be shown. Keep the information that you put on the board relevant and easy to follow.

If any of your machines require major maintenance then check your schedule board to determine the date and time for the overhaul that creates the least disruption to your schedule. If the machine to be

overhauled is an integral part of a production flow then several options could be considered:

- a) schedule overtime after the overhaul to catch up on lost time.
- b) push the whole production line to finish jobs ahead of time.
- c) increase the production on the machine to be overhauled to accommodate the production line while the machine is being repaired.
- d) schedule overtime to repair the equipment thus reducing machine downtime.

Scheduling is also an integral part of delivery of the goods. The decision to use company-owned vs commercial transportation facilities will have a large effect on your company's cash flow. Don't forget to include the delay in getting the receipts from C.O.D. orders if you use commercial delivery services. Study the economies of both systems and also consider which will provide the best customer service; having your own truck may be a good form of advertising, but it may not be the most effective or efficient means of delivering your product. Goods must be shipped quickly because they don't generate income until your customer receives them.

Make every effort to blend long and short haul deliveries so that you are constantly moving your products out to meet delivery dates. It is up to your salespeople, distributors, or agents to keep in contact with customers to let them know how far in advance they must order to ensure receipt of the goods by their desired delivery date.

Failure to have a well-organized system of scheduling shipments hurts cash flow and customer relations. Extra costs could include overtime, storage costs of finished goods, insurance costs, etc. Above all, prompt customer service is the most important objective of scheduling.

## **Quality control**

Quality control involves making sure that your product meets the quality standards you have set.

Although an employee error might result in a customer receiving a substandard product, quality control is ultimately a management responsibility. You, as the owner/manager, must establish realistic stan-

dards for both quality and quantity, then you must ensure that these parameters are respected. Quality control is not only an element of large corporations. It is an attitude and a commitment that even the smallest business must pursue. Low quality products are usually a sign of low employee morale.

A quality control program should include the following:

1. In-process inspection built into every person's job
2. Actual random inspection of the finished product
3. Quality control of the work situation
4. Quality control of everything else that goes on in the company:
  - a) customer service
  - b) administration
  - c) image of the company
  - d) marketing and sales

**In-process inspection**, as discussed earlier in the production-line section, includes asking employees to carefully inspect their work. This would include reporting any defective workmanship or materials that pass through their stations. This is also referred to as process control where defects should be detected as early as possible so as not to compound the problem with the addition of more production time and materials.

**Random inspections** can take place at any stage of production; however, inspections must take place at the final station. For example, when the aluminum boats are thoroughly checked according to drawings and specifications, it may only be necessary to put 1 out of 20 boats through all possible tests. Some defects in unchecked boats might still get through, but it is more economical for the company to **visually** inspect all boats, and only give a **thorough** testing to 1 out of 20. Any defects in materials or workmanship should be covered in a warranty to the customer.

If the inspector knows there are new employees on the line, that 95 percent acceptance rate (1 out of 20) may drop. More boats must be pulled and inspected to ensure that the product continues to meet the same standards.

If your product includes parts or accessories, it is imperative to ensure that these are included in the correct quantity, with the necessary assembly instructions, etc.

**Quality control of the work situation** should be an ongoing program directed by the owner, foreman, or supervisor (depending on the company size). It includes monitoring the overall production operation as well as maintaining a satisfactory work environment.

Generally, work situation quality control would include checking the following:

- that employees are dedicated to producing the product with an eye to the company's best interests
- that open communication is encouraged between employees and supervisors
- that the work environment is well-organized, safe, efficient, and comfortable
- that well-planned training programs for new employees and refresher programs for long-term employees are established

**All other influences** such as customer relations, public relations, and the image of the company are handled by management in its day-to-day operations.

The following excerpt from an interview with a CASE counsellor (Counselling Assistance to Small Enterprises) is an appropriate conclusion to this section on quality control.<sup>1</sup>

Getting employees involved in the concept of quality control is not that difficult. Show them how and why you want them to strive for 100 percent effort. If you illustrate how waste can affect company profits, your employees will have a better understanding of your objectives. For instance, the scrap value of an article is usually significantly less than the value of the raw materials that were used to create it. Also, the company rarely makes any profit on an item that needs to be reworked to be salable. Showing employees the costs of waste will get them more involved in your quality control program, and, as a result, they will probably become more conscientious.

Of course, the secret to maintaining consistent quality is to be certain that new employees meet your requirements. Once you have the right people, train them properly and pay them well; this will probably eliminate 50 percent of your potential problems.

Be sure to give the job of training new employees to one of your best people. This will ensure that the trainee is told what can go wrong and what the acceptable levels of quality are. Also, the trainers are motivated through your demonstration of faith in their competence and capabilities.

The most important thing to stress with new employees is that quality comes first (after your safety program). You can't realistically expect them to immediately produce the same volume or quality of work as other employees. Be patient and allow them to build up their confidence, skills, and productivity over a reasonable period of time.

A good quality control program can be launched in any type of business. Good judgment in hiring staff will have a direct result on the quality of product that is produced. Not only will this effort save the company time and money in the long run, it will produce a team of employees which will be an integral part of your business's future.

<sup>1</sup> Federal Business Development Bank, *Small Business News*, Spring 1982, pp. 5-6.

## AN EXAMPLE OF A PRODUCTION CONTROL BOARD FOR THE XYZ BOAT MANUFACTURING COMPANY

### Instructions:

- Use colours for function (i.e. material procurement, order release, manufacturing function, final inspection, packaging, shipping, anticipated delivery)
- Use top half of space divided by dotted line for required schedule, bottom half for actual process
- Use numbers to identify function
  1. Release date of production order
  2. Material orders placed (if not in inventory)
  3. Receipt of all materials
  4. Beginning of manufacture
  5. Completion date of shearing
  6. Completion date of routing
  7. Completion date of riveting
  8. Completion date of extrusion and casting installation
  9. Completion date of seat installation
  10. Release date to cleaning
  11. Completion date of cleaning
  12. Completion date of painting
  13. Completion date of final inspection
  14. Shipping date
  15. Delivery date

(See next page for explanation.)

71

## Explanations:

- Work order 1234 (500 16-foot boats) was released to the shop on January 3rd 1983, 4 days early <sup>1</sup>. Ordering of material remained on schedule; however delivery of materials was a week late <sup>2</sup> and inventory levels of aluminum sheet did not allow for shearing to begin until the end of the sixth week <sup>3</sup>. Expediting action by purchasing managed to improve delivery by 3 to 4 days; however procurement action was not completed on schedule <sup>4</sup>. Breakdown and subsequent time for repair of shear caused production to slip by a full week <sup>5</sup>. Since the delivery date <sup>15</sup> was critical for this order, management authorized overtime for routing <sup>6</sup>, riveting <sup>7</sup>, extrusion and casting installation <sup>8</sup>, and seat installation <sup>9</sup>. This resulted in releasing order to cleaning on schedule <sup>10</sup>. Inspection <sup>13</sup> was delayed by problems of reinspection of rework on previous order, thus delaying shipping date <sup>14</sup>. Advance action by shipper managed to obtain alternative carrier and final delivery date was met <sup>15</sup>.
- It should be borne in mind that there will be a number of work orders proceeding through the plant at the same time, although they will be at different stages. The production schedule control board should therefore be brought up-to-date weekly so that management (on the advice of the Production Foreman) can react to problems on an immediate basis.
- It should further be understood that the date used for each function reports the completion date of the complete order and that a finished goods inventory may be called upon to complete the order on schedule with the late production replacing the inventory used.

## 4. Materials

Introduction .....	page 74
Categories of materials .....	page 74
Materials management .....	page 75
Purchasing .....	page 76
Materials inventory .....	page 79
Suppliers .....	page 81
Transportation .....	page 82
Conclusion .....	page 83

# INTRODUCTION

Materials in a manufacturing operation are those that are needed to make your product. These materials are usually bought, unless the capability exists to produce the materials more economically in-house.

Materials are the ingredients used to make your product; the end result will only be as good as what goes into it. It is extremely important to the success of your business to have quality materials from reliable suppliers at fair prices.

## CATEGORIES OF MATERIALS

In this chapter we will define materials by dividing them into two categories: **Direct materials**, which includes stock items, and **Indirect Materials**.

**Direct materials:** This category represents the major portion of the bill of materials for your product, and in some cases direct materials differ for the different models of your product. To refer back to our boat manufacturer, the aluminum coils, castings, seats, etc., would all be considered direct materials. Also, any special items purchased for a particular order would be included as direct materials. In Terry's woodworking operation, the planks of lumber or the inventory of table legs would be direct materials.

A subdivision of direct materials is **stock items** or materials that are common to the series of products. Generally, this can be described as those items that are continually on hand. For example, in the boat operation, this would include nuts and bolts, rivets, and paint. In the woodworking operation, screws, dowels, and knobs would be considered stock items.

Direct materials represent the major costs and include all items that are direct ingredients of the product being manufactured.

**Indirect materials:** This category covers those materials that are used in the manufacturing process but are not necessarily incorporated into the finished product. Again referring to our two examples, these would be items such as cleaning fluid, glue, sandpaper, steel wool, water sealing materials, wiper rags, wood preservatives, etc. Even sweeping

compound for cleaning the shop would be included. These materials would be part of manufacturing overhead, rather than part of the bill of materials on the invoice.

## MATERIALS MANAGEMENT

- Keep an adequate supply of working stock on hand at all times.
- An inadequate materials inventory can have the following results:
  - a) delayed production
  - b) cancelled orders
  - c) idle employees
  - d) extra charges for rush deliveries
- Whenever possible, purchase materials in sizes or forms that are the most adaptable to your operation. This may eliminate one processing stage thereby speeding up your production time.
- Purchase all items according to a carefully administered Inventory Control Plan. (Inventory Controls are discussed in more detail elsewhere in this chapter, and also in chapter 6.)

Close management of the materials function in your plant not only helps to control materials, it also plays a large part in overall production control. In a competitive market, the cost of materials often determines the success or failure of a product.

Various factors affect the cost of materials:

- Proximity to the source  
not only distance, but extra shipping costs incurred for heavy materials.
- Market price variations
- Special Processing  
it may be more economical for you to have preliminary processing work (cutting, shaping, etc.) done on the material before you receive it.
- Volume  
when feasible, purchases should be made in quantity to ensure the economies of scale, without creating an excessive inventory.

- **Outside suppliers vs internal production**  
sometimes it may be more economical for you to make a component yourself rather than buying it. Consider the alternatives carefully.

## PURCHASING

Purchasing is one of the main functions of sound materials management, and it is a large and important part of your operation, requiring close control. Your company's economic health depends upon effective purchasing:

- the right materials
- the right quantity
- the right quality
- the right price
- the right delivery method at the right time

In order to carry out the purchasing function properly, the following should be considered:

- Production schedules showing when and what material is required
- Financial status
- Inventory control, providing up-to-date information on what is in stock
- Marketing and sales, providing information on market changes and new orders
- Quality control of materials and suppliers
- Legal opinions on contract matters

No matter what the size of the business these factors must all be considered. In a very small operation, one person, namely the owner/manager, may have complete responsibility for all of the above; but, whenever possible, key employees or business advisors should be consulted.

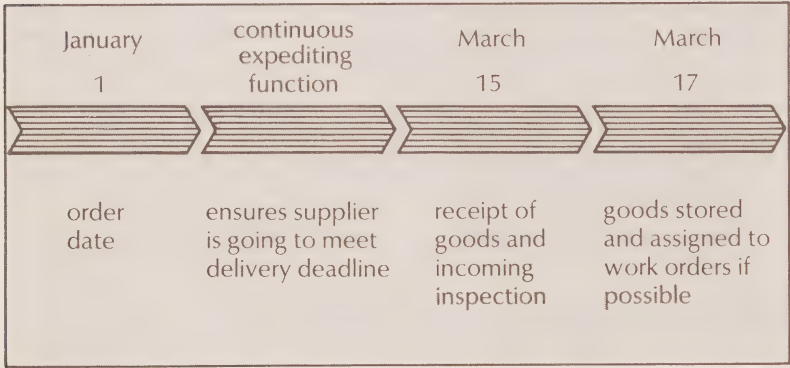
**Indirect materials and stock items** are bought on a minimum-maximum (min-max) basis using the basic production plan as a guideline for quantities. These items must be in stock at all times, as they are used in almost every production run.

Min-max means that when an item reaches a minimum stock level it is automatically replenished. An order will be placed to bring the inventory up to the maximum level of that item, which has already been established by the company.

Min-max levels should be constantly reviewed and, if necessary, levels adjusted according to the investment cost of the item and the replacement cycle. (See chapter 6 for a sample of an Inventory Control Card.)

**Direct materials** (excluding stock items) are bought according to production scheduling and planning in a custom operation, or on a min-max basis for standard manufacturing. It is extremely important to know the delivery cycle for these materials.

The time frame on this type of ordering can be illustrated as follows:



## The purchasing process

The purchasing process consists of many steps, all of which contribute to overall materials management.

1. A work order for a certain quantity of a certain product
2. Preparation of a Bill of Materials (according to the predetermined product specifications). (An example of a Bill of Materials is provided in chapter 6.)

A **Bill of Materials** includes the following information:

- everything that goes into the product, both direct materials and supplies
  - quantities of each part or component
  - part number (When parts are numbered there is less chance of making mistakes when reordering. It is also easier and more accurate when making requests for parts.)
  - recommended suppliers
  - unit price, and total cost
3. Careful notation of delivery time on all parts required
  4. Preparation of purchase orders
  5. Placing of orders on basis of delivery time. Knowing which orders should be placed today for delivery in four months, and which can be delivered almost immediately upon receipt of an order. Avoid stocking up on items that can be ordered on short notice.
  6. Checking your delivery deadlines. If you have established a good relationship with your suppliers, then you can be relatively certain that your order will be delivered on time. It never hurts to double check. If the delivery is late, your production will be delayed, perhaps resulting in costly overtime charges or the customer cancelling the order.
  7. Storekeeping and incoming inspection of goods
    - checking against the purchase order regarding quality, quantity, and price
    - goods assigned numbers or whatever classifications used by company
    - goods stored
    - purchasing and production informed that goods have arrived

## Quality control

Quality control of materials plays another important part in your materials management.

Those responsible for purchasing can control the quality of goods received from suppliers, but first they must know the specifications, which should state exactly what quality is required. If suppliers aren't given exact specifications and told what quality is acceptable they cannot be held responsible for inferior quality or even unsatisfactory service.

Often you can inspect the materials at your supplier's business and you can also check the goods upon delivery before final acceptance. There is usually an agreement between the purchaser and the vendor. If it is practical and more convenient for you, ask for raw materials to be certified by the vendor before receipt. •

Specification of standard parts should be checked with special care. Standard components can be checked by random sampling, and special parts should be checked for all critical dimensions. The more complicated the material, the more complicated the checking process. For example, the boat manufacturer must make sure that the aluminum is the right gauge and correct width; the cabinetmaker must ensure that the wood is clear and straight.

The number of employees required to carry out the purchasing duties depends upon the size of the company, and the complexity of the production. A company the size of "XYZ," the boat manufacturer, would likely have on staff a purchasing agent, an expeditor and transportation organizer, and a manager in charge of stores. Our small cabinetmaker would have one person to do all three jobs, probably himself — the owner/manager.

Whatever the size, every company should have an established and complete set of information, records, and controls including:

- catalogues, brochures, etc., from suppliers and prospective suppliers
- old and new requisitions
- lists of all materials the company buys, (with complete specifications) this might include engineering drawings
- purchase orders, receiving records, and correspondence with suppliers
- directories, technical handbooks, government documents (regarding sales taxes, restrictions, etc.)
- trade magazines

## **MATERIALS INVENTORY**

The inventory management function is usually the responsibility of the purchasing staff. Sometimes the person in charge of stores also looks after inventory depending upon the complexity of each department and the volume of goods handled.

Your supply of materials represents an asset, but also represents a cost. Inventory control means striving for a level of inventory that will give you the materials you need for production, without costing too much for storage and capital costs. The more unused goods that are stored, the more money you have tied up. It is important to remember that old or obsolete stock often loses its value as an asset, and you may eventually lose your investment.

So, how do we determine what is an adequate inventory level? Under purchasing procedures it was mentioned that supplies such as screws, rivets, paint, etc. are ordered continually or on a min-max basis, while direct materials for custom work would be ordered depending on manufacturing orders. In standard manufacturing, the direct materials would also be ordered on a min-max basis to ensure an adequate supply at all times.

The min-max levels should be continually reviewed. These levels are determined by the amount of materials needed on hand to keep up to production orders without being overstocked; however, if levels get too low, you could run into problems, such as getting a large, rush order and finding out that your supplier is unable to deliver your materials immediately.

Generally, raw materials turn over on a monthly basis, unless there is a purchasing advantage in ordering larger quantities. This advantage must be weighed against the costs of storing the excess inventory (interest, space, shrinkage, etc.). Your investment in materials can be determined by your orders. If the lead time on an item is three months, then your ordering point should always take this into account. The buying pattern is set. Based on your plans and forecasts (as discussed in chapter 1) calculate whether you can make it through all production schedules with this kind of lead time; i.e., enough materials on hand to meet schedules, as well as enough money to buy replacement materials and supplies.

Materials management also requires that you keep pace with the changes and developments affecting the marketplace and your suppliers. If your product depends upon aluminum, for example, and you hear of a pending strike at your supplier's plant, you would naturally be worried if this company were your main supplier. Even though the company has enough inventory to meet customer needs for the next six

months, you may not want to take a chance, as the strike may go on a long time. You could go ahead and make an inventory investment beyond the normal delivery cycle, or take immediate steps to find an alternate supplier. You should also watch for any upcoming price increases and, if practical, purchase your order (either regular or double) at the old price and ask for extended shipping dates.

A good purchaser watches lead times. If lead times are getting short, you will not have to buy as much. If lead times are getting longer, you may have to buy more. If necessary, suppliers can be contacted regularly to accelerate the process, thereby ensuring an adequate supply of materials in the plant.

Your purchaser must be constantly alert to any newly-developed substitute materials that may be more durable or even less expensive. The company should at least test the substitute for process suitability and you should check with your customers to determine its acceptability.

It is good business to develop as many sources as you can for your materials, so that you do not become too dependent on one supplier.

## **SUPPLIERS**

Establishing a good relationship with your suppliers can have the long-term benefit of helping you to have the best materials when you need them. It can save you money, headaches, and time, if you don't have to thoroughly inspect every shipment when it arrives at your receiving dock. Never take quality for granted, but a regular supplier can generally be depended upon to deliver materials that meet your specifications.

Some companies have a vendor rating system whereby each supplier is rated according to several factors:

- reliability
- delivery
- quality
- number of rejections
- cooperation
- prices and payment terms

Each of these points should be kept constantly under review. If a disturbing trend develops, you may want to reconsider your reasons for using a particular supplier. You should try to keep up-to-date on the supplier's business as well. For instance, if your supplier is having labour problems and, after a strike, settles for 10 percent, it is likely that the prices of materials will go up. In this case you might want to buy ahead in order to save money, or you may decide to change suppliers.

## **TRANSPORTATION**

Reliability of transportation is another outside factor which can make or break your production schedule. Some suppliers will provide their own shipping/delivery service while others may use commercial transportation. In order to avoid problems, you must know which transportation methods and which companies you prefer, and how transportation systems operate. In cases where commercial transportation services are used, you want to be able to advise your suppliers on how you want the goods shipped, rather than leaving the shipping choice to your supplier.

Time is an important consideration, and you should always try to have some control over transportation. Know all aspects: pick-ups, deliveries, traffic interchange systems, routes, labour problems, and other sources of transportation in times of need.

### **Transportation Tips**

- costs skyrocket if deliveries are unreliable
- know your transportation companies, their prices, and their reliability
- clearly specify to suppliers what you want, and when you want it
- verify all shipments

Of course, if the supplier has included delivery in the price then you don't have much choice as long as deadlines are met. But if you are paying the shipping, you can specify "cheapest," "fastest," "safest," or whatever best suits your company.

# CONCLUSION

Materials management is fundamental to the success of your business. It should now be apparent that it is necessary not only in order to have ongoing production; it can also have a critical effect on the financial condition of your business. Sound materials management is like walking on a tightrope: carefully balancing the factors to reach your ultimate goal of success.

Remember that you need:

- the right materials, at
- the right price, in
- the right quantity and
- the right quality, at
- the right time.



## 5. Labour

Introduction .....	page 86
Labour and manufacturing time .....	page 87
Manufacturing time chart .....	page 88
Overtime .....	page 90
Motivation .....	page 90
Communication .....	page 90
Incentive programs .....	page 91
Training and education .....	page 92
Conclusion .....	page 95

# INTRODUCTION

In previous chapters we discussed machinery, materials, and the production line. These areas require people to make them functional; without labour, your other resources cannot be mobilized. For a company to achieve its goals, effective integration of all elements is essential.

No matter how good your plans are, how you set up production, or how well you monitor materials, all your efforts could be in vain if you don't have the cooperation of your employees.

Employees in the smaller firm often develop very strong attachments to the business; these feelings should be mutual. Your employees are the key to your company's reputation. It is they who are ultimately controlling the effectiveness and efficiency of your operation and, consequently, your eventual success.

As the owner/manager of a small manufacturing firm you have the advantage of being able to personally monitor results and reward performance. It is this personal touch that gives so many smaller firms that slight edge over their larger competitors.

To attain a truly effective operation, you require an organized approach to the utilization of all company resources, including the leadership you provide to employees. Remember, productivity can simply be explained as "Performance = Ability X Motivation."

A successful relationship with employees begins with the following:

- communicating company goals to employees
- striving for employees' personal commitment
- offering appropriate training and development programs
- providing competitive compensation and incentives

## LABOUR AND MANUFACTURING TIME

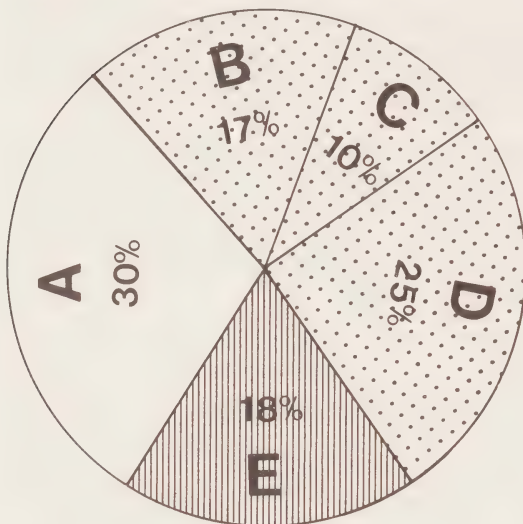
According to a study by the International Labour Office (Geneva), almost 70 percent of total manufacturing time could be made more productive by reducing inefficiencies in product design, production processes, management, and workers.

This is not to say that only 30 percent of manufacturing time is productive labour. In actual working conditions of a successful operation, the "productive" labour utilization should be approximately 75 percent. Generally, the actual nonproductive time is in the area of 18-25 percent and includes equipment set-up time, machine maintenance, wash-up time, personal time, lateness, coffee breaks, etc.

The chart on page 88 illustrates, according to the Labour Office Study, how manufacturing time is made up in a typical manufacturing operation. The total manufacturing time is subdivided into five components: A, B, C, D, E. The actual "worker production time" is approximately 80 percent; however, the "pure" productive work is determined to total only 30 percent. Obviously, by analyzing what "impurities" exist in your own operation and making improvements in only a few areas you may be able to increase your overall efficiency, production, and profitability. Your employees will be better motivated if they feel that management is taking steps to improve procedures without creating a "sweatshop" environment.

Staff communications, suggestion boxes, etc., could contribute to improvements in many areas. Also, spending time on the shop floor is one of the best ways for you to see the more obvious inefficient use of time, space, or people in your operation.

## MANUFACTURING TIME CHART



- A. "Pure" productive work. 30%
- B. Additional work due to poor production methods. 17%
- C. Additional work due to poor product design. 10%
- D. Ineffective time controllable by management. 25%
- E. Unproductive worker time. 18%

### A) Productive work

This is the "pure time." The actual, effective, and efficient time spent on production.

### B) Additional work due to poor production methods.

This could include the following:

- Bad plant layout contributing to wasted time of either the employees or the products moving from machine to machine.
- Wrong tools or less than ideal machinery being used to do the jobs. This affects not only production time but also employee morale.
- Poor production process.

### **C) Additional work due to poor design or specifications**

This could include the following; some of which could be corrected during initial sampling runs:

- Poor product design contributing to less than satisfactory production processes. Inaccurate specifications leading to a higher reject rate or higher rate of waste.
- No component standards to use as a quality control tool to determine acceptability down the line. Defective components may not be detected until final assembly or final inspection.

### **D) Ineffective time controllable by management**

This could include the following:

- Poor production planning, including scheduling of large and small jobs, continual operation of machines, consistency of product type.
- Poor materials management contributing to an idle production waiting for materials.
- Poor machine maintenance program contributing to idle production waiting for repairs or parts.
- Poor training program leading to employees having to learn on the job, resulting in higher level of rejects.
- Poor safety program resulting in shutdowns as a result of accidents or regulations.
- Poor working conditions leading to plant inefficiency and poorly motivated staff.

### **E) Unproductive worker time**

This could include the following:

- Equipment set-up time, machine maintenance, etc.
- Allowable coffee breaks, meal time, and washroom.
- Carelessness resulting in employee having to rework the item.
- Idle conversation, personal business, absence, and lateness.

## OVERTIME

The majority of owner/managers only consider overtime labour when they have temporary production overloads or special rush jobs; but, sometimes it is worthwhile to consider overtime during regular production runs.

If your fixed costs have been absorbed in the regular production, then your overall costs per unit should be less during overtime production, even if you are paying more than the normal hourly rate. With overtime production, however, be sure that the output and quality remain consistent with your normal production standards.

## MOTIVATION

Employees who care about their jobs and the company are bound to work more efficiently and to make fewer mistakes.

Motivation begins with communication. Providing clean, comfortable, and safe working conditions is also very important.

Everyone is motivated in slightly different ways; however, there isn't a secret formula to guarantee a motivated staff. Some people are motivated solely by money, others want recognition or power. Some employees will do more than their share if given constant encouragement, while others work better if they are left alone.

It is as important for you to understand these motivational factors and your employees, as it is to know the technical specifications of your product.

## COMMUNICATION

Keep your employees informed about the status of the company, your future plans, new contracts, upcoming projects, and other news which they may be interested in. Employee newspapers, bulletin boards, and staff meetings should be used whenever possible. No matter what the size of your business, you should make every effort to establish a teamwork atmosphere in your business.

Encourage employees to take part in production line inspection as part of your quality control and safety programs. When given this opportunity, employees will generally report any production difficulties or faults in the system and reveal any unsafe conditions.

Direct or face-to-face communication is best in these situations. If your operation is big enough, ideas can be given to a supervisor who in turn will take them to the plant manager. Staff meetings to discuss how to correct situations are excellent. If properly conducted, meetings can encourage a free and honest exchange of ideas. Suggestion programs with nominal monetary awards often result in substantial savings or improved efficiency; all suggestions should be acknowledged and those that are put into action should be posted on the employee bulletin board.

On **routine** visits through the shop make a point of stopping to chat with some of the employees, and acknowledge others. Don't always talk to the same ones. This makes employees feel involved, and it also smooths the way for other more serious conversations in the future.

## INCENTIVE PROGRAMS

There are numerous types of incentive programs, but the best is one designed to meet the needs of your company and your employees.

If you already have an incentive plan or are thinking about implementing one, you should ensure that it is fair to all employees. You wouldn't want employees in one section to earn incentives more easily than others.

*The XYZ Fishing Boat Manufacturing Company initiated an incentive program to help boost employee morale and increase production. Management calculated that it took 12 hours to make one boat, and that if employees worked faster they could get one extra boat through the production line each day. If employees were offered the proper incentive the company might be able to produce an extra boat per day without having to pay extra labour for it. Taking the above into consideration, an agreement*

*was made with employees: if production exceeded the mutually agreed accepted standard, then the company would put an amount equal to half the production costs for one boat (or part) into a trust fund. This money would be paid semiannually in the form of bonuses to those who contributed to the plan. In this situation the employees motivated and monitored themselves. Management found that the employees were anxious to get the bonuses, and that production increased without incurring a reduction of quality.*

The above is an example of an incentive plan for a particular operation. Each incentive plan must be tailor-made for each specific operation and must be administered fairly to be effective. Some companies use profit sharing (after a predetermined level has been reached) as a way of motivating staff and maximizing production.

When employees share in these types of incentive plans they often develop a closer identification with the business, since their production output is having a very real impact on their personal income.

## **TRAINING AND EDUCATION**

Tied in closely with communication, motivation, and incentive programs, are training and education. A good training program will increase your efficiency and productivity, build employee loyalty, and improve company morale.

A company that offers training to its employees is one that cares about its employees. Training can be on-the-job training, or company-paid outside courses. Whatever the program, employees sense that the company is serious about improving their skills.

The kinds of training programs that you might develop in-house, or look for outside the company, will depend upon the required skills of the employees. If you need highly skilled people you may even be eligible for assistance from the federal or provincial governments. If you require less skilled employees you can likely do the training yourself, but you

should also investigate the chances of government assistance for your training programs.

Although many small and medium sized manufacturers recognize the need for training skilled personnel, they often overlook the importance of training unskilled employees. Even the plant floorsweeper should be given both verbal and written instructions about the job.

Job descriptions can actually be a form of training in that they provide the employee with a written definition of duties. The posting of operating procedures for each job (as discussed in chapter 3, Production) is another form of training and reinforcement.

A job description should be prepared for every person in your operation. It should include specific duties, general areas of responsibility and accountability, number of subordinates, and the immediate supervisor. This will ensure that your employees know exactly what is expected of them, and it should also eliminate any unnecessary duplication or overlap of responsibilities.

You should periodically evaluate each employee in a personal interview with the employee's immediate supervisor, and then a subsequent discussion with the employee directly. This is an opportunity not only to review work performance but also to discuss any difficulties or problems, such as a low level of production efficiency due to a lack of proper tools, procedures, or other factors. One of the most important results of this periodic evaluation process is that those employees who can be considered for advancement are easily identifiable.

If, according to your market plan, you will need to increase staff in the near future, you should start training your present employees as soon as possible. This will ensure that they will be ready to move on to new assignments or assist in training the new employees. Confused or insufficiently trained employees on a production line will have an adverse affect on your production and profitability.

In an in-house training program it is important to pick one of your best operators (with communication skills) to do the training. You want to do everything possible to ensure that the job procedures are explained completely and that the new employee understands the quality standards that you have set for your products.

The people who are chosen to train the newcomers will also be encouraged and motivated by your demonstration of faith in their competence and capabilities. The most important thing to stress with new employees is that, after safety, quality comes first. Be patient and allow the trainees time to build up their confidence, skills, and productivity over a reasonable period of time.

### **Goals of Training**

- improve employee performance
- prepare employees for new or updated jobs
- prepare employees for promotion
- increase employees' flexibility
- reduce accidents and improve safety practices
- improve attitudes of employees towards their jobs
- reduce wastage
- improve materials handling
- orient new employees
- teach employees about the plant expansion program

### **Types of Training**

- on-the-job
- internal classroom
- combination
- external

Outside educational opportunities such as courses, conferences, or seminars benefit both the business and the employee by introducing different approaches and new ideas. You may also benefit from the company exposure received by sending some of your key people to these outside sessions.

Employees should be selected for training based on the goal of the program as well as on their individual aptitudes, capabilities, previous experiences, and attitudes.

## CONCLUSION

The key to smooth production is to have a good work environment with the proper tools and machinery operated by sufficiently trained and motivated personnel.

No matter how well you treat your employees you must still pay competitive, fair wages. (For information on wages try your trade association, chamber of commerce, board of trade, the Canadian Manufacturers' Association, Labour Canada, other federal or provincial departments, etc.) Incentives such as bonuses or profit sharing may help boost production and increase employees' enthusiasm. Encourage your staff to make suggestions or constructive criticisms; you should listen attentively, seriously considering their ideas. Finally, ensuring that your employees understand the company's role in the marketplace and your plans for the future will go a long way to creating a loyal and hard-working team.



## 6. Controls

Introduction .....	page 98
What are controls? .....	page 98
Types of controls .....	page 99
Labour .....	page 99
Materials .....	page 102
Inventory Control .....	page 105
Manufacturing overhead .....	page 108
Manufacturing work orders .....	page 108
Management controls .....	page 113
— profit and loss .....	page 113
— balance sheet .....	page 115
— financial ratios .....	page 115
— break-even analysis .....	page 116
— productivity measurement .....	page 118
Conclusion .....	page 119

# INTRODUCTION

In the previous chapters we discussed various forms of control in each individual area: planning, marketing, production, materials, and labour. Controls are basically a management information system and, in the next few pages, we will provide some examples of specific control mechanisms that can be used in small and medium sized manufacturing concerns. Since financial controls such as record-keeping and cash flow forecasts have already been covered in Volume 1 of the "Minding Your Own Business" series, we will only cover the main points in this chapter.

## WHAT ARE CONTROLS?

Controls facilitate the management of any small manufacturing concern by helping you to recognize, predict, and influence the vital steps in reaching your planned objective. Controls help you identify weak or inefficient areas and help to keep your costs in line. Without effective controls you have no way of knowing whether a job is on target or if you are running a profitable operation.

Basic controls are a must, but they should not be overused to the point where analysis is affecting productivity. The nature and extent of controls will vary depending upon your plant, your management, and how accurate and how detailed a system you want.

Controls give management the kind of information they need to operate a manufacturing plant properly, and it is up to management to interpret this information as quickly as possible to correct any potential problems or to capitalize on opportunities. A good decision is based on getting accurate information and acting on it promptly. Good management takes the information, absorbs it, and acts upon it when necessary.

Using controls is a key part of a firm's success and generally is based upon four factors:

1. initiating the necessary controls to provide **timely** information
2. interpreting that information and **determining if corrective action** is required
3. requesting **clarification** when necessary
4. making **decisions as quickly as possible**

# TYPES OF CONTROLS

There are many types of controls which can be used by a business. In this chapter we will look at six of the principal areas of controls in small and medium sized manufacturing businesses:

1. labour
2. materials
3. inventory control
4. manufacturing overhead
5. manufacturing work orders
6. management controls (financial statements, ratios, etc.)

You must gather information in each of these areas. This can be done by using very simple forms and reports. You can design your own or use the following examples as guidelines. The forms should present the information so that it can be easily analyzed in several different ways.

## LABOUR

Depending on the type of product you manufacture and your type of operation, labour can represent one of your largest expenses. It can be divided into two components, direct and indirect labour. The proper control of both areas will lead to a smoother operation because each has a strong influence on the other.

**Direct labour** consists of your employees' time when they are totally engaged in production.

The efficiency of direct labour is dependent on systems being put in place to reduce waste and costs, improve plant layout, raise the skill level of operations, increase quality supervision, and motivate employees.

**Indirect labour** consists of the manpower that does not necessarily affect the construction or composition of the finished product. Indirect labour could include inspection, materials handling, sweepers, cleaners, and maintenance.

In addition to the motivational programs, job descriptions, regular employee performance reviews, and quality control standards discussed

in chapter 5, some kind of actual performance control system should be maintained on a regular basis. If yours is a labour intensive operation, a daily or weekly time sheet should be a permanent control; however, if yours is a machine intensive operation it may be simpler to record the machine running time, which would automatically include the operator's time while the machine is in use. You must, of course, record the operator's time while the machine is idle.

A weekly time sheet (see next page) will give you an accurate total of the labour devoted to a particular job. This can be used to monitor the accuracy of your cost estimates and also as a control mechanism in comparing with previously acceptable time standards.

Another very basic reason for a weekly time sheet is that it provides you with an accurate count of regular and overtime hours worked for payroll purposes. For this reason alone, this type of control is necessary in any size or type of manufacturing operation. An example of a simplified weekly time sheet for a small operation follows on the next page.

A weekly time sheet provides the necessary data for you to evaluate several aspects of your operation:

- a) compute the total number of hours to finish a certain job (controlled by a work order number) and determine whether you are in line with your estimate of time needed to complete the job;
- b) compute the labour cost of a job;
- c) review the indirect labour involved and determine whether it is normal or too high. If it is high (perhaps due to an unexpected machine breakdown), the cost of the job will increase. Without this type of control it would be impossible to determine the reasons for unusually high labour costs on a job.

N.B.: It is important that overtime does not become a regular occurrence. Overtime should be restricted to temporary production overloads or special rush jobs.

## EMPLOYEE

WEEK ENDING

WORK ORDER NUMBER	MONDAY REG O/T	TUESDAY REG O/T	WEDNESDAY REG O/T	THURSDAY REG O/T	FRIDAY REG O/T	SATURDAY REG O/T	TOTAL REG O/T
INDIRECT LABOUR							
TOTAL							

BALANCED TO PAYROLL.

Although time clocks are used in many plants, the smaller operation that uses weekly time sheets will require the full participation of employees. If you want your employees to report productive and non-productive direct labour costs on a job be sure to explain your purpose clearly. The employee may be reluctant if the percentage of indirect (or nonproductive) time were excessive relative to total paid time. It is important that you tell your employees how this information will be used and that a consistent increase in nonproductive time is not necessarily their fault, but could be that of management.

The plant supervisor is responsible for ensuring that the work load is properly divided so that the percentage of indirect to productive labour does not vary too much between employees. An analysis of the work orders and the appropriate time sheets should reveal any changes that could be made in your production process. You could also speak directly with employees to identify any problems and to determine if productivity could be increased by (a) sharing in the workload of another employee in the production line; (b) being equipped with better tools; (c) being given a larger share in the production sequence. In any case, converting an excessive percentage of indirect labour to direct (productive) labour is the continuing responsibility of management, and employees should always be encouraged to communicate any productivity suggestions.

The comparison between the total number of hours paid and the total number of productive hours worked is a useful tool in measuring utilization of **direct** labour.

For more information on labour controls in the small and medium sized manufacturing operation, refer back to chapter 5.

## **MATERIALS**

Materials generally represent the second major cost area for a manufacturing operation. Controls in this area begin when the material is purchased for each job. A **Bill of Materials (BOM)** should be completed for each purchase. This BOM accompanies each work order and is a control over what is being purchased or taken from inventory for each job.

The Bill of Materials has several uses as a control mechanism in a small manufacturing concern:

1. to record the materials and costs in each job
2. to keep an accurate record of where stock is going and in what quantity
3. to interpret variances in material costs for standard jobs. If the BOM shows that the actual price has increased considerably then you must act quickly, because you should have been aware of this earlier to input the increase into your price estimate. Make sure that the price increase was not in error and then decide whether you can still afford to use that material. You may have to change materials or adjust your selling prices. In good times, information such as this can keep your plant on track and help you to increase your firm's profitability. In bad times, this kind of information will help you catch potential problems before they cause a crisis.

Job cost variances can be due to other reasons:

- a) an inaccurate bill of materials
- b) small parts lost due to carelessness, or shrinkage due to internal or external theft
- c) small tools and other equipment were replaced and incorrectly added to BOM as a materials cost
- d) other factors such as labour increases, machinery repairs, and equipment purchases

On the next page is an example of a Bill of Materials combining **actual** costs and **standard** costs for the materials used in production of a component for a particular job.

## Page \_\_\_\_ of \_\_\_\_

Estimate No. \_\_\_\_\_

Registration Number \_\_\_\_\_

Date \_\_\_\_\_

lob:

Finished product \_\_\_\_\_

[illegible]

## INVENTORY CONTROL

As discussed earlier, inventory controls must be established for raw materials, production or work in process, and finished goods. None of these can be neglected without jeopardizing your operation. You want to have enough raw materials on hand to keep up production; you want enough work in process to keep up with orders; and you want enough finished goods to keep up with demand.

Due to the characteristics of each inventory type and the wide variety of the products, many manufacturers use an inventory control system, that classifies materials or finished goods by nature and value depending on cost, size, usage, and life expectancy of product or material. This is the ABC classification system which divides your inventory into three groups:

- Class A items, which require careful control. These are items that can have a high cost per unit, high usage, erratic or seasonal use pattern, an irregular or long lead time for supply or production, and/or a high degree of obsolescence or deterioration.

Inventory control of Class A items generally includes perpetual inventory records, constant visual checks, and regular physical counts.

- Class B items, which require some monitoring. These are less expensive than Class A items. They have an average usage, a regular use pattern, a stable or short lead time, and an unlikely chance of obsolescence or deterioration.

Inventory control of Class B items generally includes visual checks, perpetual inventory record for high use items, and intermittent physical counts.

- Class C items, which require a minimum of control. These are usually the least expensive items. They can also have a low usage, a constant or predictable use pattern, a stable or short lead time, and/or a very rare chance of obsolescence or deterioration.

Inventory of Class C items is usually on a simple min-max basis, as discussed in chapter 4, with occasional visual checks.

The purpose of the ABC classification is to identify the degree of inventory control required for each item. While the ABC classification

deals with the raw materials and finished goods inventories, the work-in-process inventory must not be overlooked. The work-in-process inventory can be the most critical of inventories for the manufacturer.

Too high a level of work-in-process inventory may mean an excess in finished goods. Too low a level may mean shortages of finished goods in stock with a resulting loss in sales. As well, the monies tied up in work-in-process inventory actually have minimal market value. Why? Because the monies tied up in the production process can only be recovered when production has been completed and finished goods are available for sale. Partially assembled or partially transformed products have little immediate realizable value. This is in contrast to excessive raw materials, which may be returned to the supplier or sold, and to excessive finished goods, which may be discounted and sold.

Careful inventory control is necessary for the work-in-process inventory, the Class A items of the raw materials inventory, and the finished goods inventory. Class B items receive some monitoring, while Class C items receive a minimum of structured control.\*

\*adapted from Management Clinic 9, *Inventory Control for Manufacturers*, Federal Business Development Bank, p. 7.

An explanation follows for the perpetual inventory control card that appears on page 107.

- items "on order" are added to the balance to yield "total available" even though they haven't yet been received.
- once "on order" items are received they are transferred to "in stock."
- items "on reserve" for an upcoming job are subtracted from "total available."
- once "on reserve" items are issued they are subtracted from the "in stock" column.
- once "total available" column reaches the minimum point, the item should be reordered.

ITEM	MIN. QUANTITY
CODE	MAX. QUANTITY
UNIT	ORDER QUANTITY
	NORMAL MONTHLY TURNOVER

107

## MANUFACTURING OVERHEAD

Overhead costs generally include all costs other than direct labour and material. Administrative costs, management and sales staff salaries, clerical supplies, light, heating, insurance, taxes, etc. should all be included. You may, however, be interested in knowing what your **manufacturing** overhead is. This would include all supporting functions, other than administration and sales, that are required by direct labour employees in the performance of their jobs.

Examples of manufacturing overhead charges are as follows:

1. physical workplace, meaning plant or shop
2. tools
3. indirect materials to fabricate product
4. indirect labour
5. Workmen's Compensation, UIC, CPP
6. heating, lights, power, and other utilities
7. business and property taxes and insurance
8. depreciation costs of the machinery and building

Regular records of overhead costs, and calculations of a percentage of applied overhead to estimated overhead, may illustrate any significant trends in your overhead costs. This makes it easy to determine if overhead items are out of line.

You can determine your overhead cost per unit produced by dividing the overhead costs by your planned production. If sales exceed planned production levels your overhead costs per unit should decrease. Conversely, since overhead costs are relatively fixed, decreasing your planned production will increase your unit costs. It is important to monitor overhead costs closely to ensure that they don't overburden an otherwise profitable operation.

## MANUFACTURING WORK ORDERS

Each project should have a work order and a work order number. This number is the control for that project, and it should appear on all documents related to the project, including the purchase order, receipts, storage forms, and transportation bills.

The work order sets in motion the planning for purchasing materials; determining the labour requirements, production and machine times; scheduling production; and setting completion dates.

When the project is finished, the labour that went into it is charged to the work order number. Accounting closes off the work order for the costs of labour and materials, and management can then determine whether production costs for the job were within the estimate.

The following is an example of a manufacturing work order:

MANUFACTURING WORK ORDER

MANUFACTURE: \_\_\_\_\_

Serial No. \_\_\_\_\_

AUTHORIZED COSTS: \_\_\_\_\_

Date \_\_\_\_\_

Labour \_\_\_\_\_ hours

Material \_\_\_\_\_

Date begun \_\_\_\_\_

Date promised \_\_\_\_\_

Date completed \_\_\_\_\_

Comments \_\_\_\_\_

Signature of Supervisor \_\_\_\_\_

FOR OFFICE USE ONLY

	Estimate			Actual			Variance		
	Hours	Rate	Amount	Hours	Rate	Amount	Hours	Rate	Amount
Labour									
Material									

	Estimate		Applied		Variance	
	Rate	Amount	Rate	Amount		
Plant Overhead						

TOTAL ESTIMATED COSTS

\$ \_\_\_\_\_

TOTAL ACTUAL COSTS

\$ \_\_\_\_\_

VARIANCE

\$ \_\_\_\_\_

COMMENTS

\_\_\_\_\_

Our example shows a work order that consists of two sections: the first identifies the work order by serial number and date, and provides authorization for the manufacture of a quantity of products within certain labour and material costs; the second section allows you to compare actual vs estimated costs and determine variances.

The first part of the work order also shows, in addition to the date of issue, the date when work commenced and the date when the work order was completed. A space exists for any comments that might amplify or describe some of the problems encountered, in order to justify any possible increase in costs beyond those authorized.

The second section is very important, since you are comparing the estimate upon which your selling price is based to your actual costs in three categories: labour, material, and manufacturing overhead. Comparing successive work orders will illustrate any trends and will also show the cost efficiency of large vs small orders.

Estimated labour hours and rate should be based on accepted production standards for that type of job. Any variance between actual and estimated hours or rates will affect the total dollar amount charged to the job.

The material section should provide the estimated costs on the BOM (Bill of Materials) measured against actual costs, again to provide a comparison.

Manufacturing overhead is most significant. The difference between estimated overhead and applied overhead produces a variance which may be the result of a number of external factors that are important to management. Manufacturing overhead should be a fixed cost that shouldn't vary from order to order, although the applied per unit cost will vary depending on the product and quantity.

The last item on the work order sums up the total estimated costs and the total actual costs. The comment section should be used to point out discrepancies or areas that require investigation and correction.

## Work order summary

You can do a monthly summary of work orders which will show you if your production costs have increased or decreased that month. Variances can be caused by many factors:

- labour (new staff, illness, new techniques, etc.)
- materials (quality, cost, shortages, etc.)
- machinery and equipment (breakdowns, servicing)
- tools (inadequate or breakage)

Naturally these variances will affect your costs, but at least you will know why costs have fluctuated. You can then decide what to do about it next month.

The quarterly summary of work orders contains critical performance criteria. This information is used to establish obvious trends and to highlight the necessity to investigate manufacturing costs, profit margins, and possible price adjustments. It also provides a basis for the timing of such possible price changes, as well for the revision of the operating budget.

If your actual costs exceed the estimated costs you would be wise to investigate your production methods; don't simply raise your unit price, as you might price yourself out of the market. Remember, you shouldn't pass on the costs of **production inefficiencies** to your customers.

An example of a quarterly summary follows on the next page.

## PERIOD

From \_\_\_\_\_ To \_\_\_\_\_

[illegible]

## ANALYSIS AND ACTION

Total sales value of production

Total cost of goods produced

## Gross profit

Gross profit percent

Gross profit percent previous quarter

Comments -

[illegible]

## MANAGEMENT CONTROLS

The effects of all of the previous controls are reflected in the company's operating profit and loss statement. More than just a financial report that you prepare for your banker, this is a management tool that can be used in many other ways:

- alert you to existing or future problems
- measure profit or losses
- measure productivity and inventory levels

### Profit and Loss Statement

Each item in the Profit and Loss statement (P & L) bears a measurable relationship to each other. If compared to previous statements, performance fluctuations can be revealed. The P & L is a summary of business activity for a certain period of time; some businesses prepare monthly statements while others find a quarterly statement serves their needs. Some companies prefer to express each category of expense as a percentage of gross sales, which makes it easier to spot any developing trends. For example, if the percentage of machinery and plant repairs has been running consistently at 5 percent of gross sales, and suddenly in one period it jumps to 10 percent, then obviously you should investigate the reasons and take corrective action.

Certain manufacturers prefer different comparative figures by virtue of the type of market and product they are concerned with:

1. expressing all direct labour, materials, and overhead as a percentage of cost of sales
2. expressing direct overhead as a percentage of direct (productive) labour
3. relating the inventory values to annual turnover
4. relating the individual nonproductive labour to direct labour costs
5. relating total indirect labour to direct labour costs

Factors 4 and 5 are very important comparisons because they alert management to any basic changes in productive labour and production.

If indirect labour has been consistently 20 percent of the total labour payroll, you have in effect an 80 percent productive level of direct labour. This percentage will vary for the different products and dif-

ferent classes of production. Any change in consistent averaging would alert management to the fact that while payroll costs are static, employees are not as productive as in the past.

SAMPLE OF A PROFIT AND LOSS STATEMENT									
PERIOD	Months Ended 19			Months Ended 19			Months En 19		
NET TOTAL SALES									
COST OF GOODS SOLD									
Opening Inventories									
Material Purchases									
Closing Inventories									
Material Cost									
Labour									
Overhead (Excl. Depreciation)									
Depreciation									
TOTAL COST OF GOODS SOLD									
GROSS OPERATING PROFIT *									
SALES EXPENSES									
Selling Salaries									
Travelling									
Advertising									
Commissions									
Shipping & Delivery									
Truck Automobile Expenses									
Depreciation									
General									
TOTAL SALES EXPENSES									
ADMINISTRATION & FINANCIAL EXPENSES									
Executive Salaries									
Office Salaries and Wages									
Professional Fees									
Telephone, Telegraph, Telex									
Office Expenses									
Insurance and Taxes									
Rent									
Depreciation									
General									
Interest & Bank Charges									
Discounts (Net)									
Bad Debts (Net)									
TOTAL ADMIN. & FINANCIAL EXP.									
TOTAL SELLING, ADMINISTRATION FIN.									
OPERATING PROFIT BEFORE TAXES									
Add Other Income									
Provision for Profits Taxes									
Deductions (Drawings, etc.)									
NET PROFIT OR LOSS									
Add Total Depreciation									
AVAILABLE CASH FLOW									

\*The gross profit percentage (gross margin) can be a very useful yardstick for measuring production efficiency and the adequacy of your selling price. It provides you with a means of relating your month-to-month, quarter-to-quarter, and year-to-year levels of efficiency as well as, in many cases, indicating how these levels measure up to the trade in general.

Obviously you should try to attain the optimum gross margin for your business by setting your price at a competitive level, which will allow for consistent sales, and keeping your manufacturing costs at the lowest possible level while maintaining an efficient operation. Once you have determined your gross margin it can be used as a standard from which you can judge your overall operation.

Your gross margin can be changed by:

- adjusting sales prices
- reducing the cost of goods sold
- increasing sales volume

## Balance Sheet

The Balance Sheet is a financial statement that, when combined with the P & L, provides you with an overall picture of your business at a certain point in time. The Balance Sheet illustrates your assets, liabilities and, by deduction, your net worth. Since balance sheets reflect the state of the business at a certain **point** in time and not for a **period** of time, it is better to prepare them at the same date every year for comparative purposes. You should prepare your balance sheet after you complete your P & L.

## Financial Ratios

Once your financial statements have been prepared you can then use the figures to perform certain calculations (ratios) to measure performance. These ratios can then be compared to accepted industry standards available from trade associations, Dun and Bradstreet, etc., to provide an indication of where your business stands. There may be special factors affecting your particular business; however, the ratios can be

used as an early warning signal. You may find it useful to calculate the following ratios for your business and discuss them with your professional advisers:

- **current ratio** is the ratio of current assets to current liabilities. The difference between the current assets and current liabilities is the working capital of the business.
- **quick ratio** (or acid test) is the ratio between current assets, excluding inventory, and total current liabilities. This ratio focuses on the immediate liquidity of the business.
- **debt to equity** can provide an indication of the financial soundness of the business by dividing your total liabilities by net worth. The term debt to equity ratio represents the long-term debt commitment of the company compared to its total equity.
- **net sales to net worth** will illustrate how effectively your invested capital is being used by determining its turnover for a certain period.
- **net profit to net sales** measures the return on net sales. The rate of your inventory turnover and sales volume should be taken into account when interpreting this ratio.
- **net sales to inventory** is useful if your business can be realistically compared to industry standards. The ratio would not be the same in a custom operation as in a standard manufacturing operation due to the volume and composition of the inventory.
- Another useful comparison would be the ratio of net sales per employee. This can be an ongoing reflection of the efficiency and productivity of your business.

### **Break-Even Analysis**

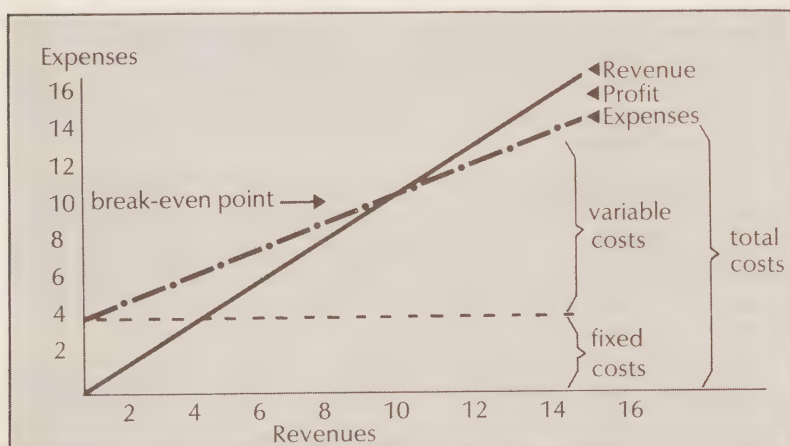
A break-even analysis is an exercise that can be done whether you're in a business now or only planning one. As the name implies, this analysis will tell you what sales volume is required to reach a point where your revenues equal your expenses. This sales volume, or break-even point, can be determined by dividing total fixed costs by unit selling price minus unit variable costs. From this calculation you can determine whether your business projections will allow you to achieve this objective.

Fixed costs are indirect costs that remain relatively unchanged in total, regardless of the production volume. Variable costs are those costs that vary directly with the volume of production or activity.

$$\text{Break-even (in units)} = \frac{\text{Fixed Costs}}{\text{Unit Selling Price} - \text{Unit Variable Cost}}$$

$$\text{Break-even (in dollars)} = \frac{\text{Fixed Costs}}{\text{Unit Selling Price} - \text{Unit Variable Cost}} \times \text{Unit Selling Price}$$

A break-even chart is a graphic illustration of the break-even point that compares total revenues to total costs.



## Productivity measurement

Productivity is a combination of the hours worked and the quality and quantity of production; therefore, the number of units produced as measured against the number of hours worked must also be measured against the number of rejects.

Some rejects are irrecoverable while others can be reworked to meet acceptable quality standards. The cost of reworking rejects, however, has to be added to the original work order.

The productivity factor is the percentage over or under the production standards laid down by the company. If the production standard for a particular product allows for 10 productive hours, and a particular unit is consistently made in an acceptable fashion with a minimum of rejects in nine hours, then the productivity factor is +10 percent.

$$\text{Productivity Factor} = \frac{\text{Production Standard} - \text{Actual Production}}{\text{Production Standard}} \times 100$$

Conversely, if the same unit is produced in 11 hours, the production factor is -10 percent.

If the productivity factor is consistently plus, you could consider lowering your price, if market pressures so indicate. If the production factor is consistently minus, management must immediately consider a critical examination of the total production process, parts and machinery, as well as the training level of employees, to determine what has to be done to improve the situation.

Two additional factors to consider in productivity are material costs and direct overhead. These should be constantly scrutinized to ensure that materials are up to company standards and that the cost of providing support services for employees is not excessive (for example, one of the key factors in overhead is the cost of tools).

Worker productivity was discussed previously, in chapter 5, where the Manufacturing Time Chart was used to illustrate the effect of various factors such as product design, production processes, and type of equipment, etc.

**Management can increase productivity** by applying what is known as economies of scale. Rather than produce three work orders of

200 units each, interspersed with other work orders for different models, you should try to set up your schedule to build 600 in one run, if you have the materials inventory. Employees will also prefer this organized production flow as it saves unnecessary “gearing up” for several repetitions of the same type of job. Also the work generally proceeds faster resulting in an increase in the productivity factor, lower costs, and improved profitability.

Not only do you get the economies of scale with a longer run, usually you will get a lower percentage of rejects.

## CONCLUSION

Controls are best when they are simple. Recording systems should be easily interpreted and evaluated. Annual trends should be recorded and compared to the previous year’s figures on a regular basis. Obviously your controls are only as good as the information used to create them; therefore, it is imperative to have a proper bookkeeping system established. Time spent in the beginning, setting up the proper system for your business will be well spent in the long run. If your business size or complexity warrants it, you should consider using a computer. Numerous commercial software packages are available to assist you in monitoring many aspects of your operation. It is imperative that you understand your manual system first; then discuss the pros and cons of a computer for your business with your advisers and colleagues.

Lastly, one of the most important considerations in developing proper controls is to listen to the advice of others. Every investment and commitment should be carefully considered and, if the figures don’t support it, then think again. Your professional advisers, your advisory board, or your board of directors will work with you in building a successful enterprise.

2576 -





Federal Business    Banque fédérale  
Development Bank    de développement







